

**CURRENT ISSUES IN FINANCING  
THE E-COMMERCE STARTUP:  
FROM INCEPTION THROUGH  
THE INITIAL PUBLIC OFFERING**

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## I. Financing The High Tech Startup From Inception Through The Early Venture Capital Round

The business and legal issues to be addressed in financing the startup business that intends to engage in e-commerce, software or another area of high tech are, for those who specialize in the area, fairly straightforward. At the same time, the number of issues that must be addressed is substantial. As in many other arenas, “the devil is in the details.”

Since the collapse of the hyperinflated venture capital and IPO markets of 1999–early 2000, the availability of startup financing is much more limited. This, and the need to satisfy more “picky” investors, means that planning for financing must therefore be very comprehensive. It starts with selecting the form of business entity and structuring the initial issuance of equities to founders and key personnel. It later entails negotiating terms and conditions of securities to be issued to “angels” and to professional venture investors.

### A. Choosing the Form of Entity for the Startup.

In determining how their venture will be financed, the founders need to choose at the threshold whether the entity should be set up as a corporation or a limited liability company (“LLC”). My bias is consistently toward the corporation, and in particular, a “C” corporation, rather than an “S” corporation.<sup>1</sup>

All businesses like limited liability. Either the corporation or the LLC model generally will provide for limited liability (so long as the appropriate procedures/formalities are observed, with certain statutory and judicially created exceptions relating to issues like environmental and products liabilities). In deciding between a corporation (either “C” corp or “S” corp) or an LLC, three key issues include: (a) tax treatment; (b) ability to compensate key employees; and (c) ability to attract venture capital.

#### 1. Tax Treatment.

##### a. “Tax-Advantaged” Entities.

Both LLCs and corporations that qualify for and elect “Subchapter S” treatment under the IRC can be treated for federal and state tax purposes like a partnership, i.e., on a “flow through” basis. Thus, (subject to certain exceptions), neither the LLC nor the “S corp” is subject to income tax at the entity level.

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<sup>1</sup>“C” corporation and “S” corporation refer to general corporate law corporations that are subject, respectively, to Chapters C and S of the Internal Revenue Code (“IRC”).

Instead, taxable income or loss of the business flows through to the entity's equity holders. Consequently, these two entities can offer several tax benefits including:

- (1) The ability to flow through to investors the tax deductions and losses that are often generated by an emerging company in its early years;
- (2) The ability of an investor to increase the tax basis of an investment in the LLC or S corporation once the entity has become profitable, by the amount of earnings that the entity retains; and
- (3) The ability to distribute earnings without incurring double-level taxation (a tax imposed on both the entity and the equity holder).

The ability to flow through operating losses to the shareholders might make an S corp or LLC attractive to an investor in a development stage enterprise, because the venture that is in the development stage will be consuming capital and generating operating losses. As between an LLC or an S corp, an LLC has advantages that result from the limitations imposed on an S corporation. Specifically, S corporations generally can have only individuals, not other corporations or LLCs, as shareholders and can have only a single class of stock (which means common stock). They also are limited to 75 shareholders, which means that the S form must be abandoned as the enterprise grows.

To cap the matter, using an S corp even for a short time will often prevent investors from qualifying for the reduced rate of tax afforded by IRC §1202 upon later disposition of stock of the entity, or the roll-over of gain resulting from such disposition under IRC §1045. (§1202 provides for a reduced rate of tax on gain recognized on the sale of qualifying stock that has been held at least five years, and IRC §1045 provides for the ability to roll-over gain recognized on the sale of qualifying stock held for at least 6 months).

As a result, the only entity a high tech venture would likely consider, other than a C corporation, is an LLC. The appeal of the LLC in California, however, has recently been diminished by the institution by the State of a tax on the gross receipts of an LLC. Thus, an LLC may have negative net income but still be required to pay taxes to California on gross revenues.

b. [The C Corporation.](#)

Notwithstanding tax benefits available to LLCs as discussed above, most startups should be set up as corporations and be taxable under Chapter C of

the IRC. One reason is the possibility of being funded by institutional venture funds. Many large venture funds are prohibited from investing in tax flow-through entities, such as LLCs, because much of their funding comes from tax-exempt institutions. Although such institutions are exempt from taxes on dividends and capital gains, they are not exempt from tax on income that would pass through to them from a business in the LLC form (or the S corporation). Moreover, the C corporation can issue tax-advantaged options to key employees under a qualified Employee Stock Option Plan. This can give key employees an opportunity for significant capital gains if the startup succeeds.

## 2. [State of Incorporation.](#)

If using a corporation for the venture, Delaware and California are the two most common states of incorporation used by California high tech practitioners. While California has a sound Corporations Code and a good body of corporate case law, and may be more convenient in some respects (*e.g.*, filings), venture capitalists typically prefer to fund a Delaware corporation—everything else being equal,—because of their perception that Delaware is a superior jurisdiction for publicly held companies. For example, Delaware corporate law allows the corporation, once it becomes publicly held, to avoid California's cumulative voting provisions. Delaware corporate law is highly developed and in particular has greater protections for officers and directors.

On the other hand, in the period before the startup achieves enough success to go public, the Corporations Code of California offers a few weapons to venture capital investors that are not available under Delaware law. For example, in California shareholders owning at least 33 1/3% of the outstanding voting stock can trigger an involuntary dissolution. This can provide a handy weapon to venture investors if the management of the startup refuses to put brakes on spending during a difficult period. This issue has surfaced recently in the context of dot.coms that have weak business models.

## B. [Initial Issuance of Shares to Founders.](#)

### 1. [In General.](#)

Founders or the startup will typically arrange to have the new corporation issue common stock to themselves at a nominal par value, such as \$.01 or \$.001 per share. Among the issues to be considered at this time are what restrictions will be required by venture investors to be placed on the founders' shares, such as: (a) vesting (decide whether future investors will require this); (b) acceleration of vesting in certain events, such as change of control and

involuntary termination); (c) right of first offer; and (d) market stand-off agreement.<sup>2</sup>

2. [Contribution of By Founders of Appreciated Property \(Particularly Technology\).](#)

The founders may own ideas, concepts, technology and other intellectual property, all of which will probably have a zero cost basis in their hands and which will have appreciated prior to the time such intangibles are transferred to the startup. The founders naturally want to avoid being taxed on the appreciation value of such property. The contribution of appreciated property to an LLC (which is treated as a partnership for tax purposes) in exchange for an equity interest in the entity will not be not a taxable event to either the contributing member or the entity. Nor will transfer of appreciated property to a corporation in exchange for stock of the corporation generally be taxable, provided that, immediately after the exchange, the transferor(s) of the property own stock representing 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of all classes of stock of the corporation.

When technology or other intellectual property rights are transferred to either a corporation or an LLC, the entity should address the issue of whether “property” is being transferred or the transferor is instead simply being compensated for past or future services although ideas and concepts generally can be deemed to be property, they must be adequately developed to qualify as property. Cash qualifies as “property” for purposes of including stock issued for cash in the 80% voting stock calculation, but if stock is issued at low valuations to founders and other service providers, an issue arises as to whether the issue price

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<sup>2</sup>Note that if the founders take unvested shares (shares subject to forfeiture) at what is then the fair market value of the shares, the founders should file an IRC §83(b) election with the IRS (and, if applicable, state tax authorities) to elect to have the tax treatment of the transaction determined at the date of acquisition. The net effect of such an election is to incur no tax liability at the time of purchase and no tax liability at the time of vesting (because the tax liability is determined based on the difference between the fair market value and the amount paid). Tax liability will be incurred to the extent of any gain at the time of sale. The §83(b) election also has the effect of beginning the tax holding period to permit the sale transaction to be taxed as a long-term capital gain for federal tax purposes if the shares are held of at least one year from the date of acquisition.

In the absence of the §83(b) election, the purchaser will be taxed on any difference between fmv and purchase price as purchaser vests in the shares and the tax holding period will not start with respect to particular shares until the purchaser vests in those shares. Where the purchaser acquires the shares for less than fmv, he or she will incur tax liability as a result of making the election, but should still consider making the election to avoid adverse tax treatment as purchaser vests in the shares.

of the stock is so far below the fair market value of the stock as to cause the stock to be considered to be issued for services, rather than “property.”

### 3. [Documenting the Entity’s Intellectual Property.](#)

An important step in preparing to obtain outside financing is to make sure that the startup’s rights in intellectual property are properly documented. Steps should be taken to ensure that any relevant intellectual property created or owned by the founders before formation of the new entity is assigned (or licensed) to the entity. At the same time, the founders should be securing (by assignment or license) any other necessary intellectual property owned or controlled by third parties.

In addition, the new venture should have agreements with all its founders, employees and independent contractors providing prospectively for protection of confidential information and assignment of all intellectual property developed in connection with the business of the new venture. In the absence of these agreements, the startup may not have full rights even to the intellectual property for which it has fully funded development.

## C. [Stock Option Plans.](#)

### 1. [General Considerations.](#)

Every new company must, early on, address the strategic use of stock options. This is emphatically the case with high tech start-ups in the e-commerce arena. In contrast to “bricks and mortar” companies, a new e-commerce company has little in the way of hard or fixed assets. Instead, the e-commerce start-up relies heavily on attracting and keeping highly qualified and creative individuals. Since its operating funds are generally limited, stock options assume a particularly significant role.

Any tech company’s stock option plan (“Plan”) should therefore be structured with four principal goals: (1) to give the company’s board of directors maximum flexibility and discretion in structuring equity compensation arrangements with its employees and other service providers; (2) to comply with requirements of federal and state securities laws and limit the board’s discretion only to the extent necessary to achieve such compliance; (3) to address the most common business and tax issues of concern to companies and employees/service providers in structuring equity compensation arrangements; and (4) to seek precision and avoid ambiguities that might otherwise be the source of future disputes between the company and its optionees. A fifth goal—to keep the actual

paperwork signed by the optionee as short and simple as possible—is often frustrated by satisfying the first four goals.

The company's board of directors should take into consideration to basic and general background information regarding key business, tax and securities law issues in reviewing the option plan and related documents and in adopting the policies that will govern them. Certain management decisions will be reflected in the contents of the Plan. However, the Plan's adoption is but the first step in the process of building an overall equity compensation program for the company's employees and other service providers. Whether the administrator of the Plan is the board of directors or the board's compensation committee, the administrator needs to adopt policies with respect to a variety of matters which will be described in the Plan but left to the discretion of the administrator.

## 2. [Tax Considerations.](#)

### a. [Taxable And Nontaxable Events.](#)

Tax considerations play a key reason for granting employees options to buy stock rather than actual shares of stock is that the grant of a stock option is ordinarily not a taxable event for either the employee or the company, whereas an award of shares of stock to an employee would be a taxable event, with the employee incurring a taxable gain on the difference between (a) the fair market value of such shares either at the time of the award<sup>3</sup> or, to the extent the shares are initially "unvested" (i.e., subject to a risk of later forfeiture or repurchase by the Internet start-up at less than fair market value at some future date, such as a termination of employment), then at the time the shares become vested,<sup>4</sup> and (b) the purchase price (if any) paid for the shares, being subject to tax at ordinary income rates.

### b. [Types Of Options: Nonqualified and Incentive Stock Options.](#)

From a tax perspective, stock options take two basic forms: "nonqualified options" ("NQOs") and "incentive stock options" ("ISOs"). In order to qualify for ISO treatment, an option must satisfy certain requirements. The most important constraints are that an ISO may be granted only to an employee (but not a director or consultant) of the company or its subsidiary or

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<sup>3</sup>Treasury Regulation ("Reg") §1.61-2(d)(1).

<sup>4</sup>Internal Revenue Code ("IRC") §83(a); Reg. §1.83-1(a).

parent company at the time of grant,<sup>5</sup> and it must be granted with an exercise price that is at least equal to the fair market value of the underlying stock as of the option grant date.<sup>6</sup>

(i) [Incentive Stock Options.](#)

(A) [Eligible Persons.](#)

As noted above, an ISO can be granted only to an individual for any reason connected with his or her employment. The option must be granted pursuant to the Plan, which in turn must set forth (a) the aggregate number of shares which may be issued; and (b) the employees (or class of employees) who are eligible for options.<sup>7</sup>

(B) [Approvals.](#)

The Plan must be approved by the company's stockholders within 12 months before or after its adoption by the board.<sup>8</sup> The statutory time limit for granting options under an ISO plan is 10 years from the date the Plan is adopted by the board or approved by stockholders, whichever is earlier, and such option by its terms must not be exercisable after the expiration of 10 years from the date such option is granted.<sup>9</sup>

(C) [Exercise Price.](#)

As stated earlier, the option exercise price for an ISO may not be less than the fair market value of the stock at the time that the option was granted. Determining the fair market value of a start-up company may be difficult, since there is no active market for the stock. However, a good faith effort to value stock will suffice.<sup>10</sup> Factors that impact upon value include the vesting schedule, the rights, preferences and privileges of any issued preferred stock and other employment-related constraints on the ability to realize any proceeds from sale of the stock. With a non-publicly traded stock, good faith effort is established by basing the exercise price on the average of fair market values determined by independent experts.

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<sup>5</sup>IRC §422(a)(2); Reg. §1.421-7(h)(1) and (3).

<sup>6</sup>IRC §422(b)(4).

<sup>7</sup>IRC §422(b).

<sup>8</sup>IRC §422(b)(1).

<sup>9</sup>IRC §422(b)(2) and (3).

<sup>10</sup>IRC §422(c)(1); Reg. §14a.422A-1, Q-2 & A-2(c)(4).

As a practical matter, few startups can afford either the time or expense of hiring such outside experts. Accordingly, some rules of thumb have evolved – although they have not been judicially tested.<sup>11</sup> Many California practitioners believe that the value of common can be reasonably pegged at 10% of the price at which preferred was most recently sold, taking account of the preferences which the preferred has upon liquidation, for board representation and otherwise, plus the uncertainty of vesting. A formula developed years ago and taught in business schools as a method of pricing options is the “Black-Scholes Pricing Model.” The Black-Scholes formula shows how six variables—the current underlying asset price (S), the option strike price (K), the option time-to-time expiration (t), the riskless return (r), the underlying asset payout return (d), and the underlying asset volatility ( $\sigma$ )—work together to determine the value of a standard option.<sup>12</sup>

#### (D) Limitations.

A stock option issued pursuant to an incentive stock option plan must be, by its terms, not transferable other than by will or operation of the laws of descent, and during the employee’s lifetime must be, by its terms, exercisable only by him.<sup>13</sup> The effective date of the grant must not be prior to the date employment

<sup>11</sup>See Reg. §1.422-2(e)(2)(ii).

<sup>12</sup>See generally Neil Chriss, *Black-Scholes And Beyond: Option Pricing Models* (Irwin 1996). Fischer Black and Myron Scholes worked together at MIT in the late 1960’s and early 1970’s to solve the problem of option valuation. They approached it from two angles; (1) they used an equilibrium model (the capital asset pricing model); and (2) they used a hedging argument proposed by their colleague Robert Merton, who had also been working on the problem with famed economist Paul Samuelson. Both approaches led to the same differential equation, known from physics as the “heat equation.” Its solution is the formula that has since then borne their names, expressed as:

$$C = Sd^{-t}N(x) - Kr^{-t}N(x - \sigma\sqrt{t}) \text{ with } x = [\log(Sd^{-t}/Kr^{-t}) \div \sigma\sqrt{t}] + \frac{1}{2}\sigma\sqrt{t}$$

S = current underlying asset price (in dollars)

K = strike price (in dollars)

t = current time-to-expiration (in years)

r = riskless return (annualized)

d = payout return (annualized)

$\sigma$  = underlying asset volatility (annualized)

For interactive use of the Black-Scholes formula, go to some of these websites:

[www.duke.edu/~charvey/fintb.htm](http://www.duke.edu/~charvey/fintb.htm)

[www.cboe.com/tools/optcalcu.htm](http://www.cboe.com/tools/optcalcu.htm)

[www.numa.com/derivs/ref/calculat/multiop/multipoa.htm](http://www.numa.com/derivs/ref/calculat/multiop/multipoa.htm)

[www.fintools.com/main.html](http://www.fintools.com/main.html)

[www.showgold.com/financial/calc1.html](http://www.showgold.com/financial/calc1.html)

[www.margrabe.com/OptionPricing.html](http://www.margrabe.com/OptionPricing.html)

[www.intrepid.com/~robertl/option-pricer3.html](http://www.intrepid.com/~robertl/option-pricer3.html)

<sup>13</sup>IRC §422(b)(5).

commences. An individual receiving an ISO must be an employee of either the company issuing the option or a parent or subsidiary of the company at all times during the period beginning on the date of the granting of the option and ending on the day three months before the date of exercise.<sup>14</sup>

An employer may not, in the aggregate, grant an employee ISOs that are first exercisable during any one calendar year in excess of \$100,000 fair market value of the stock (determined at the time the options are granted).<sup>15</sup> For example, the company can grant an employee at one time an option on \$1 million worth of stock, so long as the option does not become exercisable at a rate exceeding one-tenth per year for ten years. The stated legislative intent was to make it easier for small and relatively new companies to use ISOs as a means of attracting and motivating talented employees.

(E) [Tax Ramifications.](#)

There is no taxable event when an ISO is granted.<sup>16</sup> In general, the recipient of an ISO does not recognize income upon the exercise of the option.<sup>17</sup> The stock acquired upon exercise must be held for two years from the date of grant of the option and one year from the date of exercise in order to obtain preferential capital gains rates.<sup>18</sup> No deduction is allowed to the issuer for trade or business expenses with respect to the shares transferred to an employee pursuant to an incentive stock option plan.

However, the ISO can also trigger the alternate minimum tax (“AMT”) rules. The AMT has created some serious negative problems for venture entrepreneurs in 2000-2001. The AMT functions to recapture some of the tax breaks available to high-income taxpayers. The difference between the exercise price and the fair market value of stock obtained on the exercise of an incentive stock option is a tax preference item counted in the basic calculation of the AMT.<sup>19</sup> With the maximum rate for long-term capital gains at 28% and the maximum rate for ordinary income at 39.6%, the savings for a high-level employee not otherwise subject to AMT can be significant. For AMT purposes, the tax basis of the shares equals the market price on the exercise date (rather than

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<sup>14</sup>IRC §422(a)(2); Reg. §1.421-7(h)(2) and (3).

<sup>15</sup>IRC §422(d).

<sup>16</sup>Reg. 14a.422A-1, Q&A1.

<sup>17</sup>IRC §421(a)(1), 422(a).

<sup>18</sup>IRC §422(8)(1). The ISO holding period requirement does not apply where the ISO is exercised after the employee's death by someone who succeeded to the right of exercise. IRC §421(c)(1)(A).

<sup>19</sup>IRC §56(b)(3).

the lower exercise price).<sup>20</sup> This shows up as a “negative adjustment” at the time of sale.

Thus, an ISO optionee who eventually sells for less than the market price on the exercise date has an AMT loss (even though the optionee has a regular tax gain when the sale price exceeds the exercise price). If the optionee sells for more than the market price on the exercise date, the AMT gain will still be lower than the regular tax gain. In either case, the optionee who earned an AMT credit in the exercise year and still has not used it will likely be able to use it when he or she sells.<sup>21</sup> The problem created by the AMT in 2000-2001 was that the options were often exercised on anticipation of a public offering or shortly thereafter. The stock of the corporation at fair market had climbed steeply at the time of exercise, so there was a substantial AMT. However, the stock was subject to a six-month “lock-up” before it could be sold, which the underwriters of the IPO typically impose. When the six-months were up, the stock had dropped to a fractions of its IPO or post-IPO price, and the proceeds would not be enough to cover the AMT.

#### (F) Non-Qualified Options.

The Internet start-up typically prefers NQOs because the “spread” upon exercise of an NQO (the difference between the option price and the value of the stock) is deductible by the company as a compensation expense. In contrast, employees prefer ISOs. First, the fact that exercise of the NQO results in taxable income equal to the spread at ordinary income rates may deter NQO holder from exercising until the stock can be sold to pay the taxes. In contrast, as discussed

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<sup>20</sup>*Id.*

<sup>21</sup>Following is an example: assume that Startup.com grants an employee an ISO to buy 100 shares for \$10 per share, each at a time when the per share market price is actually \$15. Assume the employee later sells the shares at a time more than two years after the grant and more than one year after the exercise, for a net selling price of \$20 per share. For AMT purposes, applying the rules existing as of August, 2000, there would have been a \$500 positive adjustment (the spread on the exercise date). The per-share basis for AMT purposes would be \$15 (the market value on the exercise date). In the year of sale, there is a corresponding \$500 negative adjustment in order to account for the difference between regular tax and AMT basis in the shares, with the result that the AMT gain would be only \$1500 (\$2000 less the \$500 adjustment).

If the employee violated either of the ISO holding period rules by selling within two years of the grant date, or within one year of the exercise date, the sale would be a “disqualifying disposition,” with both regular tax and AMT consequences. If the sale price exceeds the exercise price, there would be a tax on the gain up to the amount of the spread at the time of exercise at the optionee’s regular tax rate. Any additional gain is capital gain. The rate on the part which is capital gain depends on the holding period, which begins on the exercise date. For example, if a disqualifying disposition is made by selling less than two years after the grant date, but more than a year after the exercise date, the capital gain qualifies for the 20% maximum rate.

above, exercise of an ISO does not trigger a taxable event for the employee (although the AMT may apply) nor a corresponding deduction for the company. Moreover, with an ISO the entire spread between the option price and the price at which the underlying stock is ultimately sold is taxable at capital gains rather than ordinary income rates (so long as certain holding period requirements are met), plus any AMT effect.

### 3. [Securities Law Considerations.](#)

#### a. [Exemptions From Registration Under The Securities Act.](#)

Neither shares of stock nor stock options may be offered, sold or granted to anyone without either registering or qualifying the transaction under federal and state securities laws or having an applicable exemption from registration or qualification under those laws. The issuance of options to employees is generally believed to be exempt from the registration requirements of the Securities Act of 1933, as amended (“Securities Act”) by virtue of the “no sale rule.” In other words, no sale of the options is deemed to occur because the grantee does not pay anything for them.<sup>22</sup> As to the underlying securities, Rule 701 of the Securities and Exchange Commission (“SEC”) provides one exemptive haven. Under Rule 701, the sale or grant by the Internet company of its stock or a stock option to any officer, director, employee, consultant or adviser of the company “in compensatory circumstances” (i.e., with an expectation of *bona fide* services being provided to the company, rather than a capital raising purpose) is also exempt from the Securities Act.<sup>23</sup>

In addition to Rule 701, SEC Rule 506 provides a sale or grant by the company to any “executive officer” or director is also exempt from registration under the 1933 Act, because executive officers and directors are, simply by reason of their position, considered to be “accredited investors,” issuances to whom are exempt as non-public.<sup>24</sup>

It is also possible to combine the Rule 701 and Rule 506 exemptions. Thus, the Internet company can use SEC Rule 701 to cover options to employees who are not executive officers or directors and therefore do not meet the definition of “accredited investors,” while using the private offering exemption of SEC

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<sup>22</sup>See, e.g., *Millennium Pharmaceuticals, Inc.*, SEC No-action Letter (May 21, 1998); *WRQ, Inc.*, SEC No-action Letter (Dec. 31, 1997); see also SEC Release No. 33-6455 (Mar. 3, 1983) (Response to Question 78 states that “in a typical plan, the grant of options will not be deemed a sale of a security for purposes of the Securities Act.”)

<sup>23</sup>See Preliminary Note 5 to SEC Rule 701.

<sup>24</sup>See SEC Rule 501.

Rule 506 (or the private offering exemption of Section 4(2) of the Securities Act)<sup>25</sup> for executive officers and directors.

Some practitioners also use SEC Rule 701 in tandem with the exemption from registration under SEC Rule 504 (which applies to offerings not exceeding \$1 million, regardless of the identity of the purchasers).<sup>26</sup> This procedure is followed in order to offer options to nonaccredited “entity” consultants (since entities are ineligible for the Rule 701 exemption) without meeting the requirements for sophistication and provision of information that apply under Rule 506.<sup>27</sup> Rule 701(f) states that offerings made under the rule are not integrated with “any other offers or sales, whether registered under the Act or otherwise exempt from the registration requirements of the Act,” hence there is a colorable argument for exemption and separation of the Rule 701 stock from the Rule 504 stock.

However, the preliminary notes to Regulation D also indicate that “Regulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act,” so an offering of Rule 504 securities combined with Rule 701 securities is not entirely devoid of risk.<sup>28</sup> Accordingly, it is better to carve up the options pool between SEC Rule 701 (for employees) and SEC Rule 506/Section 4(2) (for executive officers and directors). The officers/directors are by definition accredited under 501, hence will be deemed sophisticated for Rule 506, and the information requirements of SEC Rule 502(b)(i) then do not apply. 701(f) then avoids integrating the pools.

b. [Blue-Sky Exemptions.](#)

Because Rule 701 was enacted pursuant to Section 3(b) of the Securities Act and not pursuant to the private offering exemptions, blue-sky laws apply to issuance of securities under the rule.<sup>29</sup> However, an exemption from the qualification requirements of the applicable blue-sky laws may be available in

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<sup>25</sup> 15 U.S.C. §77d(2).

<sup>26</sup> See SEC Rule 504(b)(2).

<sup>27</sup> See SEC Rules 501 (sophistication) and 502(b)(i) (information).

<sup>28</sup> See Preliminary Note 5 to SEC Rule 701.

<sup>29</sup> Securities Act §18(b) does not include within the exemption from blue-sky regulation provided by the National Securities Market Improvement Act of 1996 those securities that are exempt from federal registration requirement by virtue of Section 3(b) of the Securities Act.

California and certain other states.<sup>30</sup> Thus, the California Corporations Code provides an exemption for offers and sales of stock pursuant to a stock option or stock purchase plan or agreement, provided that (i) the plan or agreement satisfies various restrictive requirements set forth in regulations of the California Department of Corporations and (ii) a notice of transaction is filed with, and a filing fee is paid to, the Department within 30 days of the first issuance of any stock or stock option under such a plan or agreement.<sup>31</sup>

Other less restrictive exemptions from the California securities laws may apply to certain situations, particularly to options issued to the company's directors and executive officers and to individuals and entities who are "accredited" and/or "sophisticated" investors as defined by those laws.

c. [Section 16\(b\) of the Exchange Act.](#)

Stock option plans also implicate the "short-swing" sales rules under Section 16(b) of the Securities Exchange Act of 1934 ("Exchange Act"). Of course, 16(b) will not affect the start-up in its pre-IPO phase; only when the company becomes public and becomes subject to the 1934 Act's reporting requirements will 16(b) kick in. Without attempting here a complete analysis of 16(b) issues, the Internet company's board of directors should be aware of Rule 16b-3, which exempts from the effects of 16(b) four kinds of transactions: (1) all transactions (acquisitions and dispositions) pursuant to tax-qualified and related plans (even though special rules apply to intra-plan transfers and cash distributions from such plans);<sup>32</sup> (2) acquisitions, the terms of which have been approved by the board of directors (or a committee of non-employee directors) or by a majority of

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<sup>30</sup>E.g., Arizona (*see* A.A.C. R 14-4-136); Massachusetts (MGL Ch. 110A, §14.402(a)(11) and 950 CMR §14.402(11)(a)(1)); Virginia (Va. Code §13.1-514(10)); Washington (RCW 21.20.310(10)).

<sup>31</sup>*See* Calif. Corp. Code §25102(o). It is important to note that the 30-day notice here is a condition of the validity of the exemption. Thus, if the notice is not timely filed, the exemption is lost. A few of the restrictive requirements adopted by the Department of Corporations in its Rules and Regulations are: (i) only stock with voting rights equivalent to those of other shares of the same class of stock (*e.g.*, voting common stock) may be issued; (ii) maximum vesting over 5 years, with at least 20% of the shares of any award to vest annually (although this requirement need not apply to vesting for directors, officers or consultants of the issuer); (iii) minimum option or share purchase price at no less than 85% of fair value on the grant date; (iv) a minimum 30 day "grace period" after termination of employment (except for death or disability in which case the minimum is 180 days) for employees to be allowed to exercise their options regardless of the reason for termination, except in the case of a "for cause" termination; and (v) a requirement for companies to provide their financial statements at least annually to their employees who are issued stock or granted options. Under the Code section, all options to employees can be 30% of the outstanding shares of the same class. There is a rule that exempts ISOs from qualification without the necessity of a notice of transaction (Rule 260.105.8), but this exemption limits the number of shares underlying all employee options to 10% of the outstanding shares.

<sup>32</sup>Rule 16b-3(c).

shareholders or that involve securities that have been held for at least six months;<sup>33</sup> (3) dispositions that have received similar director or shareholders approval;<sup>34</sup> and (4) discretionary transactions that result in intra-plan transfers in or out of an issuer's securities fund or cash withdrawals from such a fund.<sup>35</sup>

4. [Business Decisions And Common Practices For Internet Companies: Is There A "Standard"?](#)

As noted above, the Internet company's board of directors will have a number of important decisions with respect to the options that may be granted under the Plan. Some of these decisions will be embodied in the Plan itself (either as fixed rules governing all options to be granted or "default" decisions that will apply to all options unless expressly stated to the contrary in the stock option agreement governing the option grant to a particular employee) or in particular option agreements to be entered into with optionees in the future. The main points of discretion left to the board or compensation committee as Plan administrator are usually set forth in one section of the option plan, with the "default" positions on many of these issues being set forth in a different section.

Many common practices have grown-up in technology industries with respect to providing equity to employees and independent contractors. These practices arise out of the securities law requirements and tax considerations discussed above. At least as important, observing "standard" practices can be extremely important in attracting and retaining employees. During the stock market drop of 2000-2001 and the accompanying "nuclear winter" in venture capital, some of these practices have been adjusted. Despite common practices, there are very important choices that the Internet company needs to make within the narrow band of what is "typical." Following are the key decisions and typical practices in technology companies:

a. [Eligibility.](#)

Typically, start-up companies provide that all directors, officers, employees, independent contractors, advisers and consultants to the company who are natural persons will be eligible to participate in the Plan, although the actual grant of awards will be determined by the board of directors (or a committee established by the board).

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<sup>33</sup>Rule 16b-3(d)(1), (2) and (3).

<sup>34</sup>Rule 16b-3(e).

<sup>35</sup>Rule 16b-3(f).

b. [Ability to Make Awards of Large Blocks of Shares.](#)

Employees and prospective employees tend to focus more on the total number of options granted to them than on the percentage of the company's outstanding equity that the shares covered by such options represent. A typical employee would prefer 10,000 options for shares at \$1.00 each over 1,000 options for shares at \$10.00 each, even though the dollar value is the same. This means the fully-diluted, post-money capitalization of the Internet startup after its first venture round should preferably be at least five to ten million shares of common, (on an as-converted basis). The company can then consider putting in place an equity incentive plan that has a significant number of shares, *e.g.*, between 1,000,000 and 2,000,000 shares, of common with a low par value, such as \$.01 per share. This gives the Internet company the ability to make awards in the market range in terms of both percentage and numbers of shares. Thus, 2% to 3% for a key Vice President would be 50,000 to 70,000 shares. In addition, this allows the company to establish a low exercise price for the options.

c. [Size Of The Employee Stock Pool.](#)

Most technology start-ups plan to issue between 15% and 30% of their total planned equity through the time of their "exit event" (*e.g.*, IPO or sale of the company) as employee stock and stock options. Some of the factors that affect the exact number are: (i) the total amount of investment capital the company will require; (ii) the percentage of the equity already owned by the founders and whether the founders already occupy key management positions or the company will need to use shares from the employee stock pool to recruit those key managers; (iii) the geographic location of key personnel, and whether equity-based compensation is a typical form of compensation in those locations; and (iv) whether other forms of incentives will be used for particular positions (*e.g.*, sales commissions).

In late 1999 and early 2000, practitioners observed an increase in the size of employee pools. This results in part from the personnel shortage in the startup community. The amount of equity needed to acquire a Chief Technology Officer, for example, had steadily crept upwards, as was also the case with the Chief Executive Officer, CEO and Vice Presidents of Business Development, Sales, Marketing, and the Chief Operating Officer. Venture capitalists also had sometimes tried to reduce the net effect of escalating pre-money valuations by requiring larger employee pools. In 2001, the personnel shortage is much less acute, and many key employees look as hard at cash compensation as at the equity price, particularly after seeing the unfortunate experiences of some who incurred substantial Alternative Minimum Tax (discussed above) in 2000.

The size of the employee pool is generally a material term in negotiating the private financings that are discussed in more detail below. Prior to 1999, venture capitalists would typically negotiate caps of 10-20% of the “post-money” (i.e., post venture-capital financing) equity on the amount of shares that could be subject to additional issuance to officers, directors, employees and consultants. In 1999, management was able to push the caps higher, and in some instances they disappeared. The problems of the NASDAQ marketplace and Internet start-ups that began in March-April 2000 have resulted in a strengthened ability of venture capitalists to negotiate such caps. VCs often have an opinion as to how many shares of common stock should be issued and outstanding at the time of their investment. This can affect the size of the option pool. Thus, if a VC Firm plans to put \$5 million into a company with a post-money valuation of \$10 million, and if a 20% employee option pool is needed, that would translate to an employee pool with 2,000,000 shares.

d. [Purchase Price Of Shares And Exercise Price Of Options.](#)

Although it is possible to set prices to employees at below current fair market value in cases involving non-qualified options, companies typically establish a price they believe they can justify as fair market value. This avoids certain tax problems, and creates incentives for employees to increase the company’s value from the time of the option grant. As noted above, an early stage company which has financing from venture capital funds or other independent sources may want to use 10% of the price at which preferred stock recently was sold as a benchmark for determining fair market value of common stock.

e. [Incentive Stock Option vs. Non-Qualified Options.](#)

If employees are going to receive options, should they be ISOs or NQOs? Because of changes from time to time in the tax laws and to preserve flexibility, the tech company should adopt a plan that offers the company the ability to grant both ISOs and NQOs. As discussed above, although NQOs are advantageous for the company, ISOs are better for the employee. In the employment market that characterized the high-technology sector during 1999-early 2000, the employees’ desires largely prevailed on this point. Savvy and senior employees even demanded ISOs where other employees were receiving NQOs. The significant spread between capital gains tax rates and ordinary income tax rates under current tax law, as well as the tight job market, led most Silicon Valley and Bay Area start-ups to issue ISOs to their employees. Since mid-2000, the “bargaining” position of employees on this issue has greatly diminished.

f. Vesting.

The ideal plan provides the board with maximum flexibility in establishing vesting schedules for the exercise of stock options (within legal constraints such as the 5 year/20% per year limitation imposed by the California Corporations Code and Corporations Commissioner's regulations) while establishing a "default" vesting schedule that will apply in most circumstances. In recent years, the typical default vesting schedule chosen by most technology and information industry companies has been: no vesting during the first 6 to 12 months of employment, with "cliff" vesting of between 20% and 25% of the shares at either the 6 month or one year anniversary; the balance of the shares to vest ratably each month or quarter over the next 30-48 months. According to some authorities, the most common vesting schedule is four years, with 25% vesting each year.<sup>36</sup>

g. Vesting Of Options vs. Vesting Of Underlying Shares.

Should option holders be able to exercise options that have not yet vested? Most companies permit employees to exercise only the vested portion of their options. This avoids the problem of having to recover unvested shares from a former employee who may have a dispute with the company. However, a growing number of plans permit the employee to exercise unvested options (with the issued shares remaining subject to vesting) so that the employee can begin his or her holding period for securities law and capital gains purposes.

It should be noted that an employee can suffer significant tax consequences in acquiring shares that remain subject to vesting, hence the start-up should strongly encourage any employee who considers doing so to consult with his or her tax advisor to consider this decision, and particularly the advisability of filing a so-called "83(b) election" (made under Section 83(b) of the IRC) with the Internal Revenue Service within 30 days of acquiring such shares. When stock is not vested at the time it is acquired by the employee, the employee may accelerate the income by making an election under Section 83(b). If an employee makes a "Section 83(b) election," the employee must, at the time the stock is acquired, include in taxable income, as ordinary compensation income, the excess of the stock's value at that time over any amounts paid by the employee for the stock. This is true even though the stock cannot be sold at that time to generate cash to pay the tax.

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<sup>36</sup>Maryann Thompson, *Recruitment Spotlight: Hard Numbers on Net Executive Compensation*, The Industry Standard (Nov. 1, 1999) (online at [www.thestandard.com](http://www.thestandard.com)).

If the Section 83(b) election is made, the employee will not be required to include any further amounts in income at the time the stock vests. Any increase in the value of the stock between the time it is acquired by the employee and the time it vests (as well as any subsequent increases in value until the stock is sold) will ultimately be taxed as capital gain when the stock is finally sold by the employee (assuming the stock is a capital asset in the hands of the employee). If, however, the stock does not vest and is forfeited (because, for example, the employee terminates his or her employment) the employee will be entitled only to a capital loss (again, assuming the stock is a capital asset in the hands of the employee) to the extent that the amount originally paid by the employee for the stock exceeds the amount, if any, received on forfeiture.

Thus, absent a forfeiture, the Section 83(b) election typically affects the timing and character and hence the net amount of the tax liability. Most employees who receive employer stock which is subject to vesting make a Section 83(b) election if (1) the fair market value of the stock is not substantially greater than the price paid by the employee, if any, at the time of the transfer, (2) the employee anticipates that the value of the stock will increase substantially over the vesting period, and (3) the employee does not plan to terminate his or her employment (thereby forfeiting the stock) before the stock vests.

h. [Acceleration of Vesting.](#)

For most employees, vesting generally does not accelerate. However, employees with negotiating ability can sometimes obtain accelerated vesting of all or part of their unvested options upon death, disability, termination without cause, IPO or a sale of the company. The difference between landing and not landing a desired employee sometimes can depend on the negotiation of accelerated vesting terms. In some circumstances, allowing acceleration of vesting near in time to a sale of the company could destroy “pooling” treatment of an acquisition for accounting purposes. Unavailability of pooling in turn in some instances would kill a potential deal and make the company less attractive as an acquisition candidate. This was more the case where the company agrees to an accelerated vesting arrangement within the period of up to 24 months prior to the acquisition transaction. In an attempt to avoid this accounting problem, many companies in their stock option plans adopted a blanket policy of partial or complete acceleration of vesting for all employees upon a “change of control” transaction, with the hope of later avoiding the need to negotiate special accelerated vesting arrangements with key employees closer in time to an eventual change of control transaction. However, other companies preferred to retain maximum flexibility in this regard and to deal with this issue on a case by case basis, despite the risks posed.

In light of the FASB's recent announcement ending pooling-of-interests accounting for mergers,<sup>37</sup> many companies have been reviewing the change of control protections (*e.g.*, accelerated vesting) and other award features in their stock option plans. Without the problem of pooling restrictions, companies may be tempted to eliminate automatic vesting in favor of board or compensation committee discretion. The end of pooling will also provide greater flexibility for both executives and employers. Under the pooling rules, affiliates (*i.e.*, key officers, directors and other central persons have been) prevented from disposing of their shares during the period commencing 30 days prior to a merger and ending upon the first publication of 30 days of financials for the combined entity. Such restrictions would no longer apply if pooling is eliminated.

i. [Exercise Period of Options.](#)

The most common exercise periods are 10, 5 or 7 years. Many plans require that options be exercisable, if at all, during a "grace period" shortly after termination of employment. Such a restriction is required for ISOs. Also, most plans require that options be exercised, if at all, prior to an acquisition of the company.

j. [Repurchase Right at Employment Termination.](#)

Whether the company have the right to repurchase **vested** employee shares at employment termination is an important choice for the company to make. Many plans let former employees stay on as "passive" shareholders in the company. However, some plans permit company repurchase of vested shares at "fair market value" upon employment termination. This has the effect of keeping shares in the hands of its current employees and investors, but denies former employees the right to participate in further appreciation in share value. The norm for San Francisco Bay Area technology companies appears to be to allow employees to retain vested shares (or exercise their vested options to acquire such shares) after termination of employment, the theory being that they have "earned" the right to realize any future increases in the value of the company's equity.

k. [Rights of First Refusal on Transfer.](#)

Should employees be able to sell their shares freely, or should the option plan restrict transfer of shares? Prior to the tech company's IPO, it is important to restrict transfer of shares because of securities law considerations.

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<sup>37</sup>Financial Accounting Standards Board (FASB) Statement No. 141, [Business Combinations](#), and Statement No. 142, [Goodwill and Other Intangible Assets](#) (July 20, 2001).

However, even where a transfer by an employee would comply with securities laws, many companies prefer to have a first right to purchase such shares, whether they are subject to a voluntary transfer by the employee (usually with the exception of certain bona fide estate planning transfers) or an involuntary transfer such as divorce or personal bankruptcy. This puts the company in a position to keep the shares from falling into unfriendly or unknown hands (*e.g.*, those of a competitor). From the employee standpoint, attempting to sell shares that are subject to the startup's right of first refusal can make it very difficult to find a buyer.

1. [Some Negative Considerations.](#)

While options are vital to the Internet startup, management must be aware that there are certain negative features as well. As is true of all stock-related compensation, employee options will dilute the outstanding equity. Moreover, the stock received on exercise of a private company is illiquid. Not only must the employee eventually pay the exercise price, but if the option being exercised is an ISO, the employer will not receive any tax deduction for it unless the employee makes a "disqualifying disposition" of the stock before the holding period requirements have been satisfied, in which case the employer is entitled to a deduction equivalent to the taxable income realized by the employee.

5. [Conclusions.](#)

Just as Internet technology and its economics have moved at warp speed, the practices involved in compensating key employees and consultants continue to evolve. However, the evolution occurs against a fairly stable matrix or regulations—even though some of the regulatory implications are not yet fully developed. The high tech start-up should pay close attention to these regulations from the very beginning. To do so will help avoid problems when preparing to go public.

- D. [Rounds of Outside Financing for the E-Commerce Startup.](#)

1. [Overview.](#)

E-Commerce and Internet startups are typically are financed in stages. It becomes important to project what portion of total capital needs will be required at each stage of development, tying future capital needs to clearly identifiable milestones in the business. This enables the investors in each round of financing to monitor the company's progress over time, so as to reduce risk. Successive financing rounds should be structured to enable the founders to avoid higher

capital costs that would result from raising funds at lower values well before they are needed.

## 2. [Early Stages.](#)

Accordingly, in putting together a financing strategy, the startup's capital needs should be projected over a reasonable period of time. Several financing rounds may be involved. First is what investors often call the "Seed" round. Its purpose generally is to prove technological feasibility of the product. Next is the round needed to complete initial product and development. Perhaps 12-18 months later, further funds are raised to continue product development and launch product delivery and sales efforts.

The founders may use their own funds in development of the business concept and undertaking product development. This investment can enable the startup to command a higher valuation at the time of its initial venture financing, and allow the founders to retain a larger percentage of the company's equity. Use of their personal funds also demonstrates to potential venture investors the founders' commitment to the business concept.

## 3. ["Friends and Family."](#)

As venture capital firms have increasingly pulled away from initial financings in favor of investment in later rounds, resort to "friends and family" has become even more common than before in the initial funding of a startup. This financing source can offer a relatively quick and uncomplicated funding at a valuation higher than would be offered by a traditional venture capitalist. However, such investors typically only provide funding on a one-time basis, and the friends may have unrealistic expectations.

If the startup is successful in implementing its business plan, it should be able to achieve a higher company valuation and therefore raise capital less expensively as it meets successive milestones. In addition, the terms upon which the later rounds of financing are raised may be more favorable to the company.

## 4. [The "Angel" Round.](#)

So-called "angel" investors are often willing to take more risk on very early stage ventures. Typically, an angel investor invests in smaller amounts and demands less extensive rights and privileges than do traditional venture capitalists. However, some angel investors can often help with strategic guidance. In addition, an angel investor who is well respected in the industry may lend the startup some instant credibility in the eyes of later investors. Because angel

investors usually can commit only limited resources to any one venture, they are therefore not able to provide the ongoing financing that may be required.

## 5. [The Professional Venture Capital Rounds.](#)

Professional venture capital organizations will provide funding for companies at varying states of their development. While a few venture capitalists (“VCs”) still do seed financing, most of them focus on development or later-stage rounds. From the startup company’s standpoint, it is typically better to have more than one venture investor in order to create the available sources of future financing. Except for funds that focus on seed investment, the VCs should be expected to continue to participate, either alone or along with new investors, in later rounds. Thus, it is preferable to include in the first major venture round those firms that have the ability and the inclination to provide future financing.

### E. [Putting Together the Business Plan.](#)

To approach prospective venture investors, particularly professional VCs, with an expectation of success, the startup must develop a very strategic document: the Business Plan. The Business Plan not only seeks to market the company to potential investors, but tries to disclose all the material facts about the company that a sophisticated investor would likely deem material in making an investment decision.

VCs see literally hundreds of plans each year, and lack the time to digest very many of them. It is very important to have some link to a VC through a mutual acquaintance, such as an attorney, accountant, or mutual friend. At the same time, once the VC needs the document, it should draw his attention and present a coherent, thought-out strategy. The startup should view its Business Plan (including any supplemental disclosure document) as primarily a marketing document designed to capture the attention of a VC, and secondarily as a tool to minimize risk of liability for misrepresentation and fraud, including violations of federal and state securities laws. This means that drafting a Business Plan will involve some tension between the desire to “sell” the prospective investor while at the same time avoiding potential liability based on claims of fraud or misrepresentation. The principal parts of a Business Plan are discussed below.

### 1. [Executive Summary.](#)

The Executive Summary at the front of the Plan is key to reception of the Plan. Almost all potential venture investors, particularly professional VCs, are extremely busy. Unless the Plan grabs an investor in the first few minutes of reading, there is little chance that he or she will finish reading or pursue

investment in the enterprise. To be truly effective, an Executive Summary must be short (ideally no more than two or three pages) and “punchy;” it should sell the four most important ideas (or “hooks”) that the entrepreneurs want a potential investor to remember days (or even weeks) after reading the Plan. When a Business Plan leaves the prospective investor thinking “Hey! This company really has something worth a closer look,” the investor is much more likely to take the precious time to read the rest of the Plan.

Many of the most effective Executive Summaries are actually written before the rest of the Business Plan is drafted. At other times they are written after the writer has taken steps to become distanced from the Plan for a period of time, in order to refocus from memory on the key themes that should be described in almost bullet point fashion in the Summary. Of course, the more tightly integrated and internally consistent are these themes, the more likely the reader will remember them and find them compelling. In this sense, the Executive Summary is really not a “summary” of the Business Plan at all; nor should it attempt to literally summarize every section of the Plan.

As with all “persuasive writing,” the Executive Summary (and for that matter the entire Business Plan) must be written with its audience (i.e., the type of investor) in mind. If the most likely investors know little or nothing about the relevant industry or market, then more attention must be paid to educating the reader. But even if the reader knows little about the potential market opportunity, the Executive Summary must paint the picture of this opportunity in a few broad strokes and leave the details to be more carefully explained in the subsequent text. The Executive Summary should be light on facts, emphasizing instead the general trends and opportunities, using figures sparingly to help drive home only the key trends.

## 2. [Scope of the Plan.](#)

Frequently, the Business Plan of an e-commerce startup will focus too heavily on the idea and the market opportunity, with insufficient emphasis on the company’s specific *plan to execute* on that opportunity. The Plan ought to address each functional area of the business (e.g., technology development, sales and marketing, operations, etc.). The most effective plans reflect a tight and consistent strategy common to all functional areas.

## 3. [Revenue Model.](#)

A critical element in the Plan is the revenue model. While an idea may be scintillating, the prospective venture investor is keenly interested in whether the founders have thought through the way in which the enterprise will generate actual

revenues and earnings. The assumptions in almost every model will be challenged by the investor, so the startup should go over these assumptions with care and be ready to defend them. Most investors expect the Plan to include financial projections, which show several years of projected revenues and expenses, as well as pro forma cash flow statements and balance sheets.

However, when disgruntled investors later sue a startup and its promoters, they typically allege that the financial projections contained in the company's business plan were misleading. An important line of defense is to show that all of the financial projections are easily derived from a set of "key" assumptions that are thoroughly disclosed in the Plan, ideally accompanying the projections themselves. Some sensitivity analysis can also be helpful to highlight those assumptions which are likely to have the greatest impact on the financial performance of the enterprise.

#### 4. [Market Assessment and Product Description.](#)

It is critical that the reader of the Plan be able to quickly grasp the nature of the products and/or services to be offered by the company. Too often, Business Plans are written with a great deal of technical jargon, without a clear and concise description of the company's planned product or service. Repetition of e-commerce cliches ("We will obtain instant traction in our space through 24x7 viral marketing and reactivity;" "We will be best-of-breed with high scalability") will risk turning off many jaded VCs. In addition, the Plan must convincingly demonstrate to the reader that there is, or will be, a sizable market for the company's product or service, based on an assessment of market trends and reasonable assumptions about the future.

#### 5. [Terms of the Offering and Use of Proceeds.](#)

The Plan should summarize the terms of the securities offering, either in the body of the Plan or the supplemental disclosure document which accompanies the Plan. Start-up companies tend to be more successful in raising capital if they are proactive in this respect, instead of letting potential investors dictate the terms of the offering. The summary can frequently be presented in a "term sheet" form. The terms should include at least the following: the number of shares or units to be offered (including any minimum or maximum); the price per share or unit (including the minimum number of shares/units or dollar investment for each investor); frequency and amount of interest and principal payments for offerings of debt securities; other specific rights, preferences or privileges of the security being offered, including liquidation preferences, dividend preferences, conversion privileges (*e.g.*, convertible preferred stock or convertible notes) and voting rights. In addition, the document should explain the proposed uses by the

company of the proceeds from the offering, which is likely to vary depending on whether the company achieves the minimum or maximum investment amount.

6. [Capitalization.](#)

The Business Plan or other disclosure document should specify the “pro forma” capitalization of the company after the offering, by class of stock or unit (*e.g.*, common and preferred), indicating the percentage of the company’s capital stock (for a corporation) or capital accounts and/or profit and loss allocations (for a partnership or limited liability company) that will be represented by the offered securities as well as (a) the percentage beneficially held by each of the company’s promoters, officers, directors or other controlling persons, and (b) the percentage of equity “reserved” for issuance to future employees and consultants of the business. Of course, this can only be done if an assumption is made as to the amount of securities to be sold in the offering.

7. [Management.](#)

Investors in most ventures tend to base their investment decisions as much on the perceived strength and character of the key management and technical personnel of the enterprise as on any other single factor. Therefore, the biographical information about these “key players” should be prominently disclosed, ideally in separate paragraphs for each individual. In addition to describing the relevant experience of the company’s management team, the Business Plan and/or supplemental disclosure document should disclose all material compensation and financial arrangements between the company and each of its promoters, officers, directors and other controlling persons, including all outstanding securities, or rights, warrants or options to purchase securities, of the company held by such persons.

8. [Investor Suitability Standards.](#)

In order to take advantage of certain exemptions from the registration and qualification requirements of federal and state securities laws, it is generally advisable to limit private placement offerings to only individuals and entities which are “accredited investors” for purposes of those laws. The disclosure documents should include a brief description of the accredited investor standards.

9. [Risk Factors.](#)

The inclusion of a well-written section on risk factors (either in the Business Plan or in the supplemental disclosure document) is critical to establishing certain defenses to lawsuits that may be brought under federal and

state securities laws by investors who lose all or a portion of their investments, or even those who allege that their rate of return on investment is less than what they claim was “guaranteed” to them by the promoters of the enterprise. While a “Risk Factor” section may seem to dampen the hoped-for enthusiasm of a potential investor who reads the Plan, sophisticated investors are accustomed to seeing such factors as a part of a business plan or supplemental disclosure document.

Boilerplate risk factors are not enough. Such factors can be found in nearly every business plan or prospectus, and generally fail to address the specific risks that can lead to the particular venture’s demise. One excellent place to focus attention is on the assumptions behind the financial projections (see discussion below). The more carefully the startup tailors the risk factors to the company’s actual business and strategy, and the more thought is actually given to analyzing and describing those risks, the better those risk factors will serve the company and its officers and directors as a “shield” in defending against a suit for securities fraud if things don’t go as planned.

#### 10. [Competition.](#)

One of the most important risks of any enterprise is the risk of competition from companies with far greater financial resources, with extensive sales and marketing organizations and established distribution networks. The startup should give a great deal of thought to existing or potential competitors, and how the company may be able to protect itself by creating some sort of sustainable competitive advantage—whether through the creation of proprietary positions (*e.g.*, patents, copyrights, etc.), by means of a first to market advantage, or product differentiation.

#### 11. [Misleading Statements and Omissions.](#)

The classic lawsuit for securities fraud is based on including in an offering document (such as a Business Plan or an offering memorandum) untrue statements of material fact or the failure to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. Therefore, nothing in the Plan should create an explicit or implicit “guarantee” of performance, particularly with respect to such objective measures and projections as market size, units sold, revenues or profits.

In addition, statements that read like promises of future outcomes that are only partly under the company’s control, or for that matter of future events that are largely under the company’s control (*e.g.*, product pricing or hiring dates), but which would seem to foreclose a change of mind, should be avoided, and less definitive language should be substituted.

## 12. [Disclaimers.](#)

It is also wise to add various disclaimers to the Plan, or the supplemental disclosure document which accompanies the Plan. Examples of such disclaimers are shown below.<sup>38</sup> Of course, the disclaimers to be used in any

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<sup>38</sup>PLEASE NOTE THAT THIS MEMORANDUM MERELY SUMMARIZES SOME OF THE GENERAL ISSUES THAT SHOULD BE ADDRESSED IN ANY BUSINESS PLAN AND/OR SECURITIES OFFERING DISCLOSURE DOCUMENT. DEPENDING ON THE PARTICULARS OF THE OFFERING, AND THE IDENTITY OF THE POTENTIAL INVESTORS, ADDITIONAL DISCLOSURE REQUIREMENTS MAY APPLY.

YOU SHOULD ALWAYS HAVE A SECURITIES ATTORNEY REVIEW OFFERING DOCUMENTS BEFORE THEY ARE CIRCULATED TO POTENTIAL INVESTORS.

THE SALE OF OFFERED SECURITIES IN THIS OFFERING HAS NOT BEEN QUALIFIED WITH THE CALIFORNIA COMMISSIONER OF CORPORATIONS, AND ISSUANCE OF THE OFFERED SECURITIES OR PAYMENT OR RECEIPT OF ANY CONSIDERATION THEREFOR IS UNLAWFUL UNLESS AN EXEMPTION FROM QUALIFICATION IS PERFECTED. THE RIGHTS OF ALL PARTIES TO THIS TRANSACTION ARE EXPRESSLY CONDITIONED ON PERFECTION OF SUCH EXEMPTION.

NO PERSON (OTHER THAN OFFICERS OF THE COMPANY TO WHOM REQUESTS ARE DIRECTED FOR ADDITIONAL INFORMATION CONCERNING THIS OFFERING) IS AUTHORIZED TO GIVE ANY INFORMATION OR MAKE ANY REPRESENTATIONS (WHETHER ORAL OR WRITTEN) IN CONNECTION WITH THIS OFFERING EXCEPT SUCH INFORMATION AS IS CONTAINED IN THIS MEMORANDUM AND THE ATTACHMENTS THERETO AND DOCUMENTS REFERRED TO HEREIN. ONLY INFORMATION OR REPRESENTATIONS CONTAINED HEREIN AND THEREIN MAY BE RELIED UPON AS HAVING BEEN AUTHORIZED.

RESALE AND TRANSFERABILITY OF THE OFFERED SECURITIES ARE RESTRICTED [BY AGREEMENT AND] BY APPLICABLE SECURITIES LAWS. THERE IS NO PUBLIC MARKET FOR THE OFFERED SECURITIES AND NO PUBLIC MARKET IS LIKELY TO DEVELOP. CONSEQUENTLY, THE OFFERED SECURITIES SHOULD BE CONSIDERED FOR PURCHASE ONLY AS A LONG-TERM INVESTMENT. (SEE "RISK FACTORS AND OTHER CONSIDERATIONS.")

THIS OFFERING IS SUITABLE ONLY FOR PERSONS OF ADEQUATE MEANS WHO HAVE NO NEED FOR LIQUIDITY IN THEIR INVESTMENT. ANY INDIVIDUAL (OR ENTITY) WHO SUBSCRIBES TO PURCHASE OFFERED SECURITIES FIRST MUST REPRESENT AND WARRANT THAT HE OR SHE (OR IT) IS AN "ACCREDITED INVESTOR" WITHIN THE MEANING OF THE RULES AND REGULATIONS OF THE U.S. SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES ACT OF 1933, AS AMENDED. (SEE "INVESTOR SUITABILITY STANDARDS.")

THIS OFFERING IS SUBJECT TO A HIGH DEGREE OF RISK. THE COMPANY REPRESENTS A START-UP ENTERPRISE WITH MINIMAL OPERATING HISTORY. THERE ARE SIGNIFICANT FINANCING, OPERATING, AND OTHER BUSINESS RISKS ASSOCIATED WITH THE COMPANY'S PROPOSED BUSINESS. NO PERSON (OR ENTITY) SHOULD INVEST WHO IS NOT PREPARED FOR THE POSSIBILITY THAT HE OR SHE (OR IT) WILL LOSE HIS OR HER (OR ITS) ENTIRE INVESTMENT.

PROSPECTIVE INVESTORS ARE NOT TO CONSTRUE THE CONTENTS OF THIS MEMORANDUM AS LEGAL, TAX OR INVESTMENT ADVICE. EACH INVESTOR SHOULD CONSULT HIS OR HER (OR ITS) OWN LEGAL COUNSEL, ACCOUNTANT OR INVESTMENT ADVISOR AS TO LEGAL, TAX AND RELATED MATTERS CONCERNING AN INVESTMENT IN THE COMPANY.

(continued . . . )

particular case must be carefully tailored in light of the particular offering of securities that the company may decide to pursue, and not all of the disclaimers will apply in any particular circumstance.

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( . . . continued)

THE OFFERED SECURITIES ARE BEING OFFERED IN A PRIVATE PLACEMENT TO A LIMITED NUMBER OF INVESTORS. THIS MEMORANDUM DOES NOT CONSTITUTE AN OFFER OR SOLICITATION IN ANY JURISDICTION IN WHICH SUCH OFFER OR SOLICITATION IS NOT PERMITTED UNDER APPLICABLE LAW.

THIS MEMORANDUM AND THE COMPANY'S BUSINESS PLAN HAVE BEEN PREPARED SOLELY FOR THE BENEFIT OF PERSONS INTERESTED IN THE PROPOSED OFFERING OF OFFERED SECURITIES AND CONTAINS CONFIDENTIAL INFORMATION. ANY REPRODUCTION OR DISTRIBUTION OF THIS MEMORANDUM OR THE BUSINESS PLAN IN WHOLE OR IN PART, OR THE DIVULGENCE OF ANY OF ITS CONTENTS, OR ITS USE FOR ANY PURPOSE OTHER THAN TO EVALUATE AN INVESTMENT IN THE OFFERED SECURITIES, WITHOUT THE PRIOR WRITTEN CONSENT OF THE COMPANY, IS PROHIBITED. THE OFFEREE, BY ACCEPTING DELIVERY OF THIS MEMORANDUM, AGREES TO RETURN IT AND ALL ENCLOSED DOCUMENTS TO THE COMPANY IF THE OFFEREE DOES NOT SUBSCRIBE FOR OFFERED SECURITIES WITHIN THE TIME PERIOD STATED BELOW.

THIS OFFERING WILL TERMINATE ON \_\_\_\_\_, 2001, UNLESS EXTENDED BY THE COMPANY, IN ITS SOLE DISCRETION WITHOUT NOTICE, TO A DATE NOT LATER THAN \_\_\_\_\_, 2001. IN CONNECTION WITH THE OFFERING AND SALE OF THE OFFERED SECURITIES, THE COMPANY RESERVES THE RIGHT, IN ITS DISCRETION, TO REJECT ANY SUBSCRIPTION BY ANY INVESTOR AND TO HOLD MULTIPLE CLOSINGS. THE COMPANY FURTHER RESERVES THE RIGHT TO RESCIND ACCEPTANCE OF ANY SUBSCRIPTION AT ANY TIME UNTIL THE ACCEPTANCE OF THE RELEVANT PERSON'S SHARE PURCHASE PRICE.

THE OFFERED SECURITIES WILL BE SOLD PURSUANT TO THE SUBSCRIPTION AGREEMENT AND INVESTOR QUESTIONNAIRE ATTACHED AS EXHIBIT "A" TO THIS MEMORANDUM. THE SUBSCRIPTION DOCUMENTS CONTAIN REPRESENTATIONS, WARRANTIES, TERMS AND CONDITIONS WHICH EACH INVESTOR SHOULD REVIEW CAREFULLY BEFORE INVESTING.

THE INFORMATION CONTAINED IN THIS MEMORANDUM, AND THE COMPANY'S BUSINESS PLAN, INCLUDING WITHOUT LIMITATION THE FINANCIAL PROJECTIONS HEREIN AND THEREIN, REFLECTS THE SUBJECTIVE VIEWS OF THE COMPANY'S MANAGEMENT AS TO MARKET TRENDS AND OPPORTUNITIES. REASONABLE PERSONS COULD DISAGREE AS TO THE COMPANY'S INTERPRETATIONS OF, AND CONCLUSIONS BASED UPON, PERCEIVED TRENDS, FORECASTS, AND OPPORTUNITIES. NO INFORMATION IN THIS MEMORANDUM OR IN THE BUSINESS PLAN IS INTENDED TO RESTRICT THE COMPANY FROM VARYING ITS BUSINESS PLAN IN THE FUTURE.

THE COMPANY WILL MAKE AVAILABLE BEFORE CLOSING TO ANY PROSPECTIVE QUALIFIED INVESTOR THE OPPORTUNITY TO ASK QUESTIONS OF AND RECEIVE ANSWERS FROM THE COMPANY CONCERNING THE TERMS AND CONDITIONS OF THE OFFERING AND THE BUSINESS AND OPERATIONS OF THE COMPANY, AND TO OBTAIN ADDITIONAL INFORMATION TO THE EXTENT THE COMPANY POSSESSES SUCH INFORMATION OR CAN ACQUIRE IT WITHOUT UNREASONABLE EFFORT OR EXPENSE.

F. [Typical Terms and Conditions of a Venture Investment.](#)

While the Business Plan is being formulated, the startup must consider the terms and conditions that the venture investors will be seeking. This entails evaluating the “lead” investor and the kinds of terms commonly found in venture deals.

1. [Lead Investor.](#)

In most venture rounds, one firm acts as a so-called “lead” investor. The negotiations will take place largely between the lead investor and its counsel, on one hand, and the startup and its counsel, on the other. The other investors may offer comments as terms are developed, but generally they accept what the lead negotiates.

The startup will generally prefer a “lead” that is a reputable firm with good contacts. A good lead investor is able to provide advisors that can give guidance to the startup’s management. The lead investor will typically assume one of the seats on the startup’s board of directors that is reserved for the preferred stock (see below) and is expected to be one of the startup’s principal advisors. A good venture investor can help make it easier for the startup to obtain other types of financing (banks, equipment leasing companies, etc.).

Sometimes, before a lead investor has surfaced, other less knowledgeable investors may agree to make a preferred stock investment or a bridge loan which will be automatically convertible into the same security that is ultimately issued to the lead investor’s group, at some discount from the lead investor’s price. The typical discount ranges from 10-25%.

2. [Preferred Stock Involved in Venture Investments.](#)

The vehicle by which a venture investment is made—sometimes at the angel stage, but certainly in the later venture capitalist stages—is typically convertible preferred stock. Such preferred stock is almost always voting stock, with each preferred share having one vote for every share of common into which it is convertible. Less often, debt convertible into preferred stock might be used. The convertible preferred is convertible into common stock, and it gives the holder certain preferences and privileges that are superior to the rights enjoyed by holders of the company’s common stock. The startup must be ready to negotiate various rights, preferences and privileges of the preferred stock with the venture firm. Most of these issues will be negotiated prior to finalization of the Term Sheet. The Term Sheet then serves as the basis for preparation of the detailed

documentation, such as the Stock Purchase Agreement; Certificate of Rights, Preferences and Privileges; Shareholder Rights Agreement, Etc.

Some of the important issues to be determined prior to finalizing the Term Sheet are discussed below.

a. [Liquidation Preference.](#)

Preferred stock always has a liquidation preference. The preference typically gives holders of the preferred the right to receive back the amount of their original investment per share upon liquidation or dissolution of the company before any distributions are made to holders of the common stock. Sometimes the preferred will negotiate for a return of a multiple of their original investment per share. After the preferred stockholders receive their preference amount (either the full amount of their original investment or some multiple), holders of the common receive whatever remains. The “high multiple” liquidation preference has staged a dramatic resurgence in the venture capital “nuclear winter” of 2000-2001. Some VCs are insisting on a liquidation preference of three or four times their investment before *any* other investors, including those in prior venture rounds, receive anything.

Sometimes the venture investors are “participating,” i.e., after the preferred receives back the full amount of their original investment, they share the remaining assets equally with the common. A liquidation preference typically includes declared or accrued but unpaid dividends on the preferred. This was not very common in California startup practice, particularly before this year, since it is viewed as a “double dip.” We can expect to see more pressure for double dipping through 2001.

Your clients must remember that the liquidation preference applies to many transactions other than statutory liquidation. More often in practice it will apply to an asset sale or a stock merger in which the company is not the surviving entity. In such event, the preferred stockholders may elect to treat the sale or merger as a liquidation and receive the liquidation preference before distribution of any proceeds from the sale or merger to the common stockholders. The preferred also have an alternative of converting to common prior to the sale or merger and receiving what the common stockholders receive. This election is made if the sale or merger is quite favorable.

b. [Dividends.](#)

Convertible preferred stock usually has an annual dividend, which is usually a fixed percentage of the original issuance price of the stock. This

dividend can be cumulative (i.e., if it is not paid in one year, it will continue to accumulate until eventually paid) or non-cumulative (i.e., unless declared by the Board, it does not carry over from one year to the next).

However, in current practice the dividend is generally made discretionary. Thus, it is payable only if and when declared by the board of directors. In some cases, the dividend is “capitalized,” so that any unpaid amount is added to the total original purchase price of the preferred for purposes of applying the dividend rate and for determining the preference that preferred shareholders are to receive before the common stockholders take anything.

c. [Conversion or Preferred.](#)

The general ratio for converting convertible preferred shares into common is 1:1, based on the shares as they exist at the time of financing. In other words, a preferred stockholder may convert each share of preferred stock into one share of common stock. The 1:1 ratio makes it easier to compute the voting power of the preferred.

d. [Anti-Dilution.](#)

The convertible preferred stockholder typically has anti-dilution protection that results in an increase in the conversion ratio in the event that the start subsequently sells any of its stock at a price lower than that paid by the preferred stockholder.

The concept of dilution protection is that the number of shares into which each preferred stock may be converted will be modified upon the sale of additional common (or other securities convertible into common) a lower price per share than that paid for the preferred by the venture investor. The modification is accomplished by calculating a new conversion price per share for the preferred stock. Among the different methods of calculating the “conversion price” in anti-dilution protection, the two main types are the “weighted average” and the “full ratchet.”

- (i) [“Weighted Average.”](#) The anti-dilution provision which was most commonly seen in West Coast financings, at least until late 2000, has been the “weighted average” method. This formula is more favorable to the startup, because it typically does not have as harsh an impact on the conversion ratio as the “full ratchet,” discussed below. The weighted average adjusts the conversion price of the

preferred stock in the following manner: the conversion price currently in effect is decreased as of the time of issuance of the lower price shares by multiplying such conversion price currently in effect by a fraction (i) the numerator of which is the total number of shares of common stock deemed outstanding immediately prior to the time of such issuance, plus the number of shares of common stock which the aggregate consideration received (or to be received) by the startup for the shares so issued would purchase at such conversion price, and (ii) the denominator of which is the total number of shares of common stock deemed outstanding immediately prior to the time of such issuance plus number of shares of common stock so issued.

Thus, by way of example, assuming there were 1000 shares of common stock outstanding on January 1, 2001, prior to issuance of any preferred, and the startup sold 500 shares of preferred stock to investors at \$1.00 per share, convertible at 1:1 into 500 shares of common stock, or 33 1/3% of all common stock. Then assume 500 shares of common stock were subsequently sold at \$.50 per share. The new conversion price on the earlier preferred would be  $1750 \div 2000$ , or \$0.875, and the new conversion ratio would be adjusted accordingly.

- (ii) [“Full Ratchet.”](#) The preferred holders obtain a much larger advantage in anti-dilution under the “full ratchet” method of protection. Full ratchets were uncommon until the last several months, when almost all second and third (or subsequent) round financings have been so-called “down rounds.” In other words, these rounds found the new company’s preferred selling at a price substantially below the immediately previous round. Full ratchets have in the past have also been found in very early “angel” rounds where the investors are not certain of the appropriate value to place on the startup, or in later stages where the company is in distress and the prospect of a subsequent “down” round is quite real.

In the full ratchet, the conversion price equals the most recent price per share of common stock sold by the company. Thus, assume 1,000 shares of common stock were outstanding on January 1, 2001, at which time the company

sold 500 shares of preferred stock to investors at \$1.00 per share, convertible 1:1 into 500 shares of common stock, or 33 1/3% of all common stock. Then assume that 500 shares of common stock were subsequently sold at \$0.50 per share. The new conversion price would be \$.50 per share and the conversion ratio based on full ratchet would be \$1.00 divided by \$.50, or 2. This means the 500 shares of previously-issued preferred stock would be convertible into 1,000 shares of common stock, which on an as-converted basis would equal 40% of all common stock.

Where full ratchet anti-dilution provisions are used, the ratchet generally applies regardless of how many shares of stock are subsequently sold at the lower price on which the ratchet is based. For example, even if only 100 shares of common stock were sold in the preceding example at \$0.50, the preferred stockholder would still have the benefit of the 2:1 conversion ratio, the preferred stockholder would then own stock convertible into 1,000 out of a total of 2,200 shares of common stock, or nearly 45% of the common stock.

- (iii) [Exceptions to Antidilution](#). It is customary for the issuance of common stock in certain types of transactions to be “carved out” of the antidilution provisions. Thus, issuance of lower-priced common in these situations will not trigger the calculation of a new conversion price. The transactions generally exempted from antidilution include: shares to be issued under the company’s stock option plan (often subject to some limitation or “cap” on the amount of shares that can be so exempted); shares issued to vendors, suppliers or to financial institutions in connection with loans, leases, etc. (again subject to caps); shares issued to strategic partners (also subject to caps); shares issued in acquisitions (which may be conditioned upon approval by a supermajority of the board); securities issued in a public offering in which all of the series of preferred in question will be converted; shares issued as a dividend on such preferred; and shares issued in connection with certain licensing arrangements. Of course, issuance of securities pursuant to any options or other convertible securities that are already issued and outstanding prior to the venture financing should also be carved out of the antidilution provisions.

e. [Blocking Rights.](#)

The preferred usually obtain the right to veto certain corporate transactions, such as sale of all or substantially all of the assets, a merger, liquidation or dissolution, changes to the charter and by-laws, and other significant actions, by voting as a class on such transactions.

f. [Board Representation.](#)

The preferred will generally obtain the right to name one or more of the Board of Directors of the startup. Following the venture round, a five person board would often have two members elected by the common stock, two by the preferred, and the fifth name chosen by the first four directors.

g. [Right to Force Redemption.](#)

The investors may request a right to force the preferred stock to be redeemed several years out by the company at an agreed upon price.

h. [Registration Rights.](#)

Registration rights are common in preferred stock financings. It is standard to require the company to register the common shares into which the preferred has been or is convertible, i.e., so-called “demand registration” after a certain period of time has elapsed since the closing of the preferred financing. It usually kicks in after three years of the closing of the preferred round or six months after the company’s IPO, whichever is earlier, usually three years or six months post IPO.

i. [Rights of First Refusal to Participate in Future Rounds.](#)

The right to purchase a pro rata amount of shares that are issued in the future by the startup company is commonly sought, so as to give the VCs the ability to preserve their pro rata share of the common stock of the company on an as converted, fully diluted basis, and may allow them to purchase all of the stock issued in a future financing. Certain VC deals have extended this right to participate to include the company’s IPO, which raises concern over gun jumping issues.

j. [Fees of the Investors’ Counsel.](#)

It is common for the startup entity to agree to pay the fees and expenses of counsel for the investors, up to a specified limit, out of the proceeds of the financing at the time of closing. Such payment is often made a condition of

closing in the stock purchase agreement. The limitation on the amount of investors' fees borne by the e-commerce startup is generally in the range of \$15,000-\$30,000.

## II. [Taking The High Tech Company Public On The Internet](#)

### A. [Background: The Internet as a Medium for Public Offerings of Securities.](#)

#### 1. [Internet Applications Relevant to Offering Securities.](#)

The new communication environment of the Internet enables high-speed communication on a worldwide basis at extremely low cost. These technical capabilities are having a dramatic effect on securities markets. Important capabilities of the new electronic medium include e-mail, which allows communications to be mass mailed at low cost. The World Wide Web also affords the capability of delivering pictures, text and sound in static or moving form.<sup>39</sup> Other important Internet applications in the electronic dissemination of information about securities are the bulletin board and mailing list. The bulletin board (also called a "newsgroup") differs from a web site in that it is generally controlled by more than a single person. The bulletin board allows written messages, responses and new messages from a number of persons to be posted or downloaded from a given Internet location. The mailing list provides a way for network users who share interest in a given topic to exchange messages by sending a message to a central address, where it is automatically rebroadcast to all other participants. Another capability relevant to securities transactions is "push" technology, which allows information to be sent through the Internet to pre-selected viewers automatically without the necessity of their logging on to a particular web site or bulletin board.<sup>40</sup>

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<sup>39</sup>Web sites are generally operated by a single person who controls the information appearing on the Web page. While viewers can access the sites and use its interactive features, they cannot revise the original Web page. The World Wide Web brings together file transfer protocol, hypertext files, e-mail and other resources linked together on a global basis.

<sup>40</sup>Two related types of electronic networks have applications to the world of cybersecurities: the intranet and extranet. An intranet is in effect a private Internet used to share information inside an organization. It is only accessible to members of the organization. An extranet is a collaborative network that uses Internet technology to link entities that work closely, such as businesses with their suppliers, customers, or other businesses that share common goals. An extranet usually requires a degree of security and privacy from competitors. An extranet can be viewed either as part of a company's intranet that is made accessible to other companies or as a collaborative Internet connection with other companies. The shared information can be accessible only to the collaborating parties or can be publicly accessible.

The foregoing electronic applications, particularly the World Wide Web, enable companies to offer their securities in new ways. Web sites, bulletin boards, e-mail and push technology are now used in advertising, offering and selling securities and for disseminating investment advice. The Net allows investment bankers to post new underwritings of stock issues on the Web and expose them to vast numbers of prospective investors at very low cost. The same technology permits issuers to bypass traditional underwriters and make direct public offerings (“DPOs”) of securities using the Web bulletin boards and push technology. It also makes available a platform for new kinds of intermediaries that facilitate the marketing of new issues in non-traditional ways. The increased role of the Internet in the issuance of new securities has been accompanied by efforts of federal and state regulators to adapt existing rules to fit this dynamically changing marketplace. To assess these developments, a brief overview of the regulatory framework is in order.

2. [The Regulatory Framework For Initial Public Offerings \(“IPOs”\).](#)
  - a. [Overview of Federal Regulation of IPOs.](#)

Federal regulation over issuance of new securities in the United States lies primarily in the Securities Act of 1933 (the “Securities Act”).<sup>41</sup> The Securities Act generally requires registration with the Securities and Exchange Commission (“SEC”) of securities that are publicly offered. Regulation over trading in already-issued securities lies primarily in the Securities Exchange Act of 1934 (the “Exchange Act”).<sup>42</sup> The Exchange Act generally requires registration with the SEC of those engaged in the securities business as broker-dealers and registration national securities exchanges. While both Acts address securities fraud, the focus of the Securities Act is on securities issuance while that of the Exchange Act is more broadly on both issuance and after-market trading.<sup>43</sup>

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<sup>41</sup> 15 U.S.C. §§77a *et seq.*

<sup>42</sup> 15 U.S.C. §§78a *et seq.*

<sup>43</sup> Narrower in their coverage are the Investment Advisers Act of 1940 (“Advisers Act”), which generally affects investment advisers having \$25 million or more under management or advising mutual funds, and the Investment Company Act of 1940 (“1940 Act”), which governs both open and closed-end investment companies that offer their securities to the public. The Advisers Act is 15 U.S.C. §§80b-1 *et seq.* The Advisers Act also covers investment advisers; regardless of size, who are not regulated by the state where its principal place of business is located. Advisers Act, §203A(a)(1), 15 U.S.C. §80b-3a(a)(1). The 1940 Act is 15 U.S.C. §§80a-1 *et seq.*

b. The State Regulatory Scheme in IPOs.

If a company will, upon completion of its initial public offering, be authorized for listing on the New York Stock Exchange or American Stock Exchange, or qualified for inclusion in the Nasdaq National Market System, the role of the various state blue-sky laws, that could otherwise require state qualification of the securities, is largely preempted.<sup>44</sup> However, the states have retained authority to regulate certain kinds of small offerings that are exempt from federal registration, particularly those exempt by reason of SEC Rules 504 and 505.<sup>45</sup> In addition, where an issuer registers an IPO on Form SB-2 rather than Form S-1, qualification under state blue-sky laws will still be required.

With the arrival of the Internet, a principal focus of state regulators has been on jurisdiction. Application of state “blue-sky” laws has traditionally been based on location, i.e., the laws of a given state seek to regulate transactions occurring within the state’s boundaries. Section 414(a) of the Uniform Securities Act (“USA”) thus provides that its jurisdiction reaches all persons offering or selling securities when “(1) an offer to sell is made *in this state*, or (2) an offer to buy is made and accepted *in this state*.”<sup>46</sup> As discussed later in more detail, determining whether any event takes place “in” and “within” a given jurisdiction raises new questions in the online world, since anyone with a PC and modem can access a Web site anywhere on which a securities offering is posted.<sup>47</sup> State regulators have sought to enhance marketing on the Web by creating jurisdictional safe harbors.<sup>48</sup> However, they have not yet adopted separate rules or interpretations dealing with what kind of electronic delivery will satisfy existing disclosure requirements under their blue-sky laws.

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<sup>44</sup>The National Securities Markets Improvement Act of 1996 (“NSMIA”) expressly preempted state laws in this respect. Securities Act §18(b)(4)(D), 15 U.S.C. 77r(b)(4)(D), added by NSMIA §102(a).

<sup>45</sup>Rules 504 and 505 both are based on the SEC’s authority under Section 3(b) of the Securities Act to adopt conditional exemptions for offerings not exceeding \$5 million. See discussion of “SCOR” offerings *infra* at notes 111-118 and accompanying text.

<sup>46</sup>Uniform Securities Act §414(a); *see, generally*, 1 J. LONG, BLUE SKY LAW (1997 rev.) §3.03; emphasis added. In *Diamond Multimedia Systems, Inc. v. Santa Clara County Superior Court*, 19 Cal. 4th 1036 (1999), the California Supreme Court held that Section 25400(d) of the California Corporations Code, which prohibits a person offering to purchase or sell a security “in this state” from making a misleading representation or omission, applies whether the representation or omission occurs in California or elsewhere. Congress in October, 1998 passed legislation which requires all securities fraud cases against New York Stock Exchange or NASDAQ/MNS listed securities to be brought in federal courts, although the legislation was not made retroactive. *See* Pub. L. No. 105-353; 112 Stat. §3227.

<sup>47</sup>*See* Subsection IV, *infra*.

<sup>48</sup>*See* Subsection IV.G.3, *infra*.

B. [Rules and Interpretations of the SEC Applicable to Offering Securities by Electronic Means.](#)

Since 1995, the SEC has sought by rule and interpretive release to mesh the federal Acts and the regulatory framework built up around them with the new world of electronic networks. Initially, the SEC produced two October 1995 interpretive releases and a 1996 concept release as guides regarding delivery of information on securities by electronic means.<sup>49</sup> While the early releases reflected an SEC effort to encourage electronic delivery of information to investors, they also reflected a residual regulatory preference for paper delivery and a preference for directed Internet communication (e-mail) over Web site postings.

The SEC also published in 1998 an interpretive release on the application of U.S. federal securities laws to offshore offering and sales of securities and investment services over the World Wide Web.<sup>50</sup> In 2000, the SEC further developed its views on use of electronic media in another interpretive release.<sup>51</sup> Sprinkled between and among the releases since 1995 have been several dozen SEC no-action letters which have allowed new methods of information delivery.

The Securities Act requires that issuance of securities to the public be accompanied by disclosure of specified types of material information to potential investors. Traditionally, such disclosures have been accomplished by providing prospective investors with a printed registration statement and prospectus filed with the SEC. The SEC has analogized electronic distribution of information under both the Securities Act and Exchange Act to the print medium, stating that it

“ . . . would view information distributed through electronic means as satisfying the delivery or transmission requirements of the federal securities laws if such distribution results in the delivery to the intended recipients of substantially equivalent information as these recipients

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<sup>49</sup>SEC Release No. 33-7233, 34-36345 (Oct. 6, 1995) (“First Interpretive Release”) and SEC Release No. 33-7234, 34-36346 (Oct. 6, 1995) (collectively, the “October Releases”); and SEC Release No. 33-7314, 34-37480 (July 25, 1996). The SEC also issued Securities Act Release No. 33-7289 (May 9, 1996) (“Intermediary Release”) which sets forth criteria to be used in determining whether information transmitted electronically by broker-dealers, transfer agents and investment advisers can be deemed equivalent to the same information when transmitted by paper.

<sup>50</sup>SEC Release No. 33-7516, 34-39779, IA-1710, IC-23071 (Mar. 23, 1998) (“Release 33-7516”).

<sup>51</sup>SEC Release 33-7856 (Apr. 28, 2000) (the “Electronic Media Release”).

would have had if the information were delivered to them in paper form.”<sup>52</sup>

To deliver information to investors via the Internet, an issuer (and its under writers) must meet several requirements: (1) consent; (2) adequate and timely notice; (3) effective access; and (4) reasonable assurance of delivery.

1. [Recipient’s Consent to Electronic Transmission of Information.](#)

Unlike information transmitted in paper form, an issuer must obtain the investor’s informed consent to the receipt of information through the Internet. Moreover, the SEC makes such consent revocable at any reasonable time before electronic delivery of a particular document has actually commenced.<sup>53</sup> In its April 2000 Electronic Media Release, the SEC embellished its views on requirements of the securities laws in light of the notice, access and delivery considerations that had been initially established in the First Interpretive Release. The Electronic Media Release clarifies that consent to electronic delivery of issuer communications can be given by telephone within certain limits.<sup>54</sup>

The Electronic Media Release clarifies that an issuer or market intermediary may also obtain consent telephonically, provided a record of the consent is retained.<sup>55</sup> The record should provide the same level of detail as a written consent, meaning that it should specify the medium of electronic delivery and indicate whether the consent is “global.”<sup>56</sup> Moreover, a telephonic consent must be obtained in a manner assuring its authenticity, such as where an investor is well-known to the broker seeking the consent or the investor consents to use of an automated system accessed by PIN number.<sup>57</sup>

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<sup>52</sup>First Interpretive Release, Section II.A. Compare the U.K.’s Investment Management Regulatory Organization Limited (“IMRO”), *Notice to Regulated Firms* (May 1997): “[A]ny advertisement which is place on the Internet must provide the same information as that which would be required if that advertisement were put out in printed form.”

<sup>53</sup>First Interpretive Release, Example 5.

<sup>54</sup>Earlier in the First Interpretive Release, the SEC had indicated that one means of securing evidence of electronic delivery is to obtain an investor’s informed consent to receive information through a particular electronic medium. The same release had further indicated that a consent is considered informed where the investor is informed (1) that a document is to be delivered through a particular electronic medium, (2) that there may be costs associated with delivery (*e.g.*, the cost of online time) and (3) the duration of, and types of documents covered by, the consent. The SEC had also indicated in the First Interpretive Release that informed consent could be obtained by written or electronic means.

<sup>55</sup>Electronic Media Release, II.A.1.

<sup>56</sup>*Id.*, note 22. A global consent is one that applies to all documents of any issuer in which an investor owns or buys stock through a broker-dealer or other intermediary.

<sup>57</sup>*Id.*, note 23 and Examples 1 and 2 in II.E.

Investors may give global consent to electronic delivery of all documents of any issuer (provided the consent is “informed”).<sup>58</sup> For example, including global consent as merely one provision in an agreement that the investor is required to execute in order to receive other services may not fully inform the investor.<sup>59</sup> The breadth of a global consent makes it vital that the types of electronic media to be used be specified in the consent. Identification on an issuer-by-issuer basis is unnecessary, but investors cannot be required to accept subsequent delivery by additional media without additional consent.<sup>60</sup>

Although an issuer or broker-dealer can rely on consents obtained by a third-party document delivery service, the issuer or broker-dealer bears ultimate responsibility for ensuring that the consent is authentic and that all required documents are delivered.<sup>61</sup> Broker-dealers are advised to obtain the consent of a new customer through an account-opening agreement with a separate electronic delivery authorization or through an entirely separate document. The SEC expressly states that, except in the case of brokerage firms doing business exclusively online, if the opening of a brokerage account is conditioned upon an investor providing global consent, the consent would not be considered informed and evidence of delivery would not be established.

## 2. [Necessity of Adequate and Timely Notice.](#)

Notice to investors of the electronic information must be adequate and timely. Thus, merely posting a document on a Web site will not constitute adequate notice, absent evidence of actual delivery to the investor.<sup>62</sup> Separate notice by two paper methods-letter or postcard-or a directed Internet message (e-mail) can satisfy such actual delivery requirements.<sup>63</sup> If an investor consents to electronic delivery of a final prospectus for a public offering by means of a Web site, but does not provide an electronic mail address, the issuer may post its final prospectus on the site and mail the investor a notice of the location of the prospectus on the Web along with the paper confirmation of the sale.<sup>64</sup>

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<sup>58</sup>*Id.*, notes 24-26 and accompanying text.

<sup>59</sup>*Id.*, II.A.2.

<sup>60</sup>Investors also should be advised of their right to revoke a global consent at any time and to receive all documents covered by the consent in paper form. Intermediaries may require revocation on an “all-or-none” basis if this policy is disclosed at the time the investor’s consent is obtained. *Id.*

<sup>61</sup>*Id.*, note 25.

<sup>62</sup>*Id.*, Section II.B.

<sup>63</sup>*Id.*

<sup>64</sup>First Interpretive Release, Example 10.

### 3. [Effective Access to Electronically Available Information.](#)

It is necessary that investors have access to required disclosure that is “comparable” to postal mail and also have the opportunity to retain the information or have ongoing access equivalent to personal retention.<sup>65</sup> A document posted on the Internet or made available through an on-line service should remain accessible for so long as any delivery requirement under SEC rules applies. When a preliminary prospectus is posted on a Web site, it should be updated “to the same degree as paper.”<sup>66</sup> Paper versions of documents must be available where there is computer incompatibility or computer system failure or where consent to receive documents electronically is revoked by the investor.<sup>67</sup>

The Electronic Media Release confirms that Portable Document Format (“PDF”) may be used to deliver documents so long as the format it is not so burdensome as to prevent access.<sup>68</sup> In practice, this means that issuers and intermediaries may use PDF to deliver documents to investors provided that they (1) inform investors of the requirements for downloading PDF at the time of obtaining consent to electronic delivery and (2) provide investors with necessary software and technical assistance free of charge. An issuer can satisfy the latter requirement by providing a hyperlink to a website where the software could be downloaded and a toll-free telephone number for technical assistance.<sup>69</sup>

### 4. [Reasonable Assurance of Delivery.](#)

Issuers should have reasonable assurance, akin to that found in postal mail, that the electronic delivery of information will actually occur. The delivery requirements can be satisfied by the investor’s informed consent to receive information through a particular electronic medium coupled with proper notice of access.<sup>70</sup> Sufficient evidence of delivery can also include (1) an electronic mail return receipt or confirmation that a document has been accessed, downloaded or printed; (2) the investor’s receipt of transmission by fax; (3) the investor’s

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<sup>65</sup> *Id.*, note 22.

<sup>66</sup> *Id.*, note 26.

<sup>67</sup> *Id.*, Section II.B. The Commission permits an offering to be limited entirely to persons that consent to receive a prospectus electronically, but if it is not so limited, a paper version of the prospectus must be given to broker-dealers to be made available to investors who do not have on-line access. In addition, SEC Rule 174 requires that an issuer in a public offering make paper versions available to after-market purchasers.

<sup>68</sup> Electronic Media Release, II.A.3.

<sup>69</sup> *Id.*

<sup>70</sup> First Interpretive Release, Section II.C.

accessing by hyperlink of a required document; and (4) the investor's use of forms or other material that are available only by accessing the document.<sup>71</sup>

Practical questions can arise in determining whether an e-mail delivery has actually taken place. Unlike mail sent via the U.S. Postal Service, posting an e-mail message does not yet raise a legal presumption that it was received. In most states and for federal purposes, a letter is presumptively received if it is deposited in the mails with full postage prepaid.<sup>72</sup> Accomplishing proof of receipt of e-mail can be achieved in much the same way as a receipt which the recipient of a registered letter signs upon delivery. The e-mail recipient can hit a reply button upon receipt of the electronic document, evidencing that receipt occurred. Institutions selling securities, particularly mutual funds, are concerned over identifying the true identity of a customer who gives electronic consent to delivery of a prospectus or other disclosure documents over the Internet. Such concerns have helped stimulate the creation of new systems to verify the delivery of electronic materials and their opening by recipients.

## 5. [Restrictions on Communications Before and During IPOs.](#)

### a. [Prefiling or "Quiet" Period.](#)

Apart from liberalized notice, access and delivery requirements (subsections A-D above), the procedures followed in making a securities offering in cyberspace generally follow the regulatory scheme that predated the advent of the Internet and that applies to offerings made solely by print media. Thus, when for example, if the issuer plans an offering that will be registered under the Securities Act, whether or not by electronic means, there is a ban on publicity that might "condition the market,"<sup>73</sup> such as publication of bullish information on the issuer's Web site.<sup>74</sup> The main exception available in the quiet period is SEC Rule 135, which allows a skeletal notice of a proposed offering to be published through "any medium." The notice can only include the issuer's name; the title, amount and basic terms of the securities being offered; the amount of the offering, if any, made by selling security holders; the anticipated timing of the offerings a brief

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<sup>71</sup>*Id.*

<sup>72</sup>See "Compliance Navigator: Electronic Delivery of Prospectuses," 7 INTERNET COMPLIANCE ALERT No. 7 (Apr. 6, 1998), 7.

<sup>73</sup>Section 5(b) of the Securities Act.

<sup>74</sup>Section 5(c), Securities Act, 15 U.S.C. §77e(c). However, SEC Rule 135 allows limited announcements on the Internet of upcoming offerings prior to filing of a registration statement. See also the discussion of electronic roadshows during the period prior to effectiveness of the registration statement at Subsection I.C.6, *infra*.

statement of the manner and purpose of the offering (without naming underwriters) and certain other information.<sup>75</sup>

b. Postfiling (or “Waiting”) Period.

Once the issuer has filed its registration statement with the SEC, the issuer enters the so-called “waiting” period in which it generally may make written “offers” only through the use of a preliminary prospectus, whether in paper or in written form. However, securities can be offered and offers to buy solicited, orally in person or by telephone so long as a contract is not formed.<sup>76</sup> There are a limited number of other written offers that can be made to investors, which are: (1) tombstone advertisements (general notices traditionally published in the newspaper announcing the identity of the issuer and the securities being offered pursuant to Rule 134 of the Securities Act); (2) solicitations of indications of interest; (3) promotions in the ordinary course of business; (4) analyst reports pursuant to SEC Rules 137-139; and (5) electronic roadshows. (A roadshow, discussed in more detail below, is a round of meetings and presentations in and around the United States or foreign countries in which the company’s management presents the company and its operations to potential investors and answers any questions from these individuals or institutional investor representatives.) A summary preliminary prospectus can also be used during the waiting period, but only by issuers that have been reporting companies for at least three years and meet certain other requirements.<sup>77</sup>

The issuer may also solicit indications of interest pursuant to SEC Rule 134(d) to be returned via e-mail, as long as they are solicited along with provision of a preliminary prospectus.<sup>78</sup> As discussed above, the issuer may continue to provide promotional information in the ordinary course of business and analyst reports in accordance with the same conditions and limitations. However, the issuer or underwriter must not violate “quiet period” restrictions by hyperlinking a preliminary prospectus to research reports or other information that are not found in the registration statement.<sup>79</sup>

Because any electronic communication is deemed a written offer (except for roadshows, discussed below), it must conform to one of the accepted

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<sup>75</sup>SEC Rule 135.

<sup>76</sup>However, such offers are subject to liabilities and antifraud prohibitions under Securities Act Section 12(2), 15 U.S.C. §77l(2).

<sup>77</sup>See SEC Rule 431.

<sup>78</sup>See *IPONet*, SEC No Action Letter (July 24, 1996).

<sup>79</sup>First Interpretive Release, Example 16. Such a hyperlink could violate Section 5(b)(1), Securities Act.

forms of written offers or else it is proscribed.<sup>80</sup> The company may, however, send a tombstone ad electronically as long as it conforms to Rule 134(b).<sup>81</sup> Additionally, a company can place the traditional tombstone ad in the newspapers, with a reference in the ad to a website where investors may view a preliminary prospectus.<sup>82</sup> While the preliminary prospectus included in the registration statement may be in electronic media, if posted on the same website that the issuer generally uses for its business, it should contain a disclaimer refuting any incorporation or reference to the other information of the website. One way to eliminate the potential problem of inadvertently incorporating other information is to augment the use of disclaimers by posting the preliminary prospectus on a separate and individual page.

c. [Post-Effective Period.](#)

After a registration statement becomes effective, the website containing the final version of the prospectus can be hyperlinked to other sales literature. During the post effective period, an issuer is permitted to disseminate written sales literature to prospective investors, so long as such material is accompanied by, or preceded by, a final prospectus.<sup>83</sup> In the electronic context, this means that an issuer may include electronic sales literature on its website during the post-effective period, provided that certain safeguards are satisfied. In the First Interpretive Release, the SEC stated in a series of hypotheticals that including sales literature on a website is permitted if the sales literature is in close proximity to, or directly linked to, a final prospectus. For example, sales literature that appears on the same website as a final prospectus is acceptable, so long as both can be accessed from the same menu and are in close proximity to one another on the menu. Sales literature that is placed separately on a website or an electronic bulletin is acceptable if the sales literature contains a direct hyperlink to the issuer's final prospectus.

In short, in the SEC's view, electronic sales literature will be deemed "accompanied by, or preceded by" a final prospectus so long as there exists close proximity or a direct link that would enable the final prospectus "to be viewed directly as if [the prospectus] were packaged in the same envelope as the sales

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<sup>80</sup>First Interpretive Release, note 6.

<sup>81</sup>*Id.*

<sup>82</sup>*Id.*, Ex. 19.

<sup>83</sup>Section 2(10)(a) of the Securities Act exempts from the definition of a prospectus any "communication sent or given after the effective date of the registration statement if prior or at the time of such communication a written prospectus meeting the requirements of (a) of Section 10 . . . was sent or given to the person to whom the communication was made." 15 U.S.C. §77(b)(10)(a).

literature.<sup>84</sup> Tombstone advertisements under SEC Rule 134 and other advertisements under SEC Rule 482 need not be accompanied or preceded by a prospectus and hence may be delivered electronically without raising issues under the Securities Act.<sup>85</sup>

The listing of a website address within a published tombstone is permitted under Rule 134.<sup>86</sup> In fact, the issuer or underwriter can mail sales literature to persons for whom delivery of the prospectus via the website was effective, so long as notice of the availability of the final prospectus and its website location accompanies or precedes the sales literature.<sup>87</sup> To give the investor the opportunity to access the final prospectus online, the issuer or broker can post sales materials with prominent hyperlinks to the prospectus embedded at the top of the first page of each page of the sales materials.<sup>88</sup> Another approach is to place two different hyperlinks on a web page, with one linking to the prospectus and the other to the sales materials, both clearly identified and in close proximity.<sup>89</sup>

d. [Circumstances in which Issuers or Underwriters May Be Responsible for Information on Other Websites.](#)

(i) [The “Envelope Theory”.](#)

The First Interpretive Release included examples suggesting that documents in close proximity to each other on the same website and documents hyperlinked together will be considered delivered together as if they had been sent in the same envelope. This “envelope theory” of electronic delivery from its inception has been a source of concern for issuers in registration. The Electronic Media Release clarifies that the envelope theory was intended to help issuers and financial intermediaries in their use of electronic media by insuring that, where certain documents must accompany or precede other documents, this will be deemed to have occurred.<sup>90</sup> The release also makes clear that information

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<sup>84</sup>First Interpretive Release, examples 14, 15 and 17.

<sup>85</sup>See First Interpretive Release, Questions 18 and 41.

<sup>86</sup>*Id.*, Question 19.

<sup>87</sup>First Interpretive Release, Example 17. The notice of the location of the Web Site should be in forepart and clearly highlighted. Supplemental sales literature that must be accompanied or preceded by a prospectus can be made available if prior or at the time of delivery a statutory prospectus is made available. See SEC Rule 34b-1.

<sup>88</sup>*Id.*, Question 35.

<sup>89</sup>First Interpretive Release, Questions 14 and 15.

<sup>90</sup>Electronic Media Release, II.A.4.

on a website will be considered part of a prospectus only where an issuer acts to make it so.<sup>91</sup>

(ii) [The “Adoption” and “Entanglement” Theories.](#)

While the Envelope Theory was aimed at assisting issuers in their delivery of documents, two other theories have been developed that affect the responsibility of an issuer or underwriter for third party information contained on other websites which there is a hyperlink. The New Media Release expanded on Under this release, the question whether such third party information should be attributed to the issuer is dependent upon whether (A) “the issuer has involved itself on the preparation of the information” or (B) “explicitly or implicitly endorsed or approved the information.”<sup>92</sup> In addressing issuer liability for third party statements such as analysts, the SEC as well as the courts have called the first line of inquiry the “entanglement” theory and the second the “adoption” theory. Whereas the “entanglement” theory hinges on the issuer’s involvement in preparation of materials *prior* to their publication, the “adoption” theory depends upon explicit or implicit endorsement or approval of the hyperlinked materials by the issuer *after* their publication.<sup>93</sup>

(A) [“Adoption.”](#) The Electronic Media Release noted a number of factors relevant to determining “adoption”:<sup>94</sup>

- (1) [Context of a Hyperlink.](#) If a hyperlink within a mandated disclosure document, the information is deemed adopted.<sup>95</sup> Thus, if third party information that meets the definition of an “offer to sell” is hyperlinked with an issuer or financial intermediary’s website during registration, it will be “adopted” for purposes of both disclosure liability under Section 10 of the Securities Act

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<sup>91</sup>*Id.* However, in the context of mandated disclosure, the Commission previously stated that “if an investor must proceed through a confusing series of ever-changing menus to access a required document so that it is not reasonable to expect that access would generally occur, this procedure would likely be viewed as unduly burdensome.” First Interpretive Release, Sec. II.B., note 24. The ways in which the issuer acts to include other information in a prospectus are discussed in subpart 4.b. below.

<sup>92</sup>Electronic Media Release, II.B.1.

<sup>93</sup>*Id.*

<sup>94</sup>*Id.*

<sup>95</sup>*Id.*, II.B.1.a.

and SEC Rule 10b-5, as well as raise potential “gun-jumping” or “free writing” problems. Likewise, if an issuer or financial intermediary states or otherwise implies that the hyperlinked information is supported by, or supports statements of, the issuer or intermediary, the information is deemed adopted.<sup>96</sup> An example cited by the SEC as incorporating third party site is a statement on the issuer’s site such as: “As reported in Today’s Widget, our company is the leading producer of widgets worldwide.”<sup>97</sup>

According to the release, where an issuer includes a hyperlink in its prospectus, it is appropriate for the issuer to assume responsibility for the information because the issuer has exhibited an intent to make the hyperlinked information part of its communication with the market. In such event, the hyperlinked information will become part of the prospectus and must be filed with the SEC accordingly, making the issuer and underwriter subject to liability under Section 11 of the Securities Act.<sup>98</sup>

- (2) [Risk of Investor Confusion](#). The Electronic Media Release asserts that an issuer or intermediary is more likely to be deemed to have adopted hyperlinked information if there are no precautions taken to avoid investor confusion as to the source of the information.<sup>99</sup> The Release suggests that an intermediate screen clearly and prominently indicate that the viewer is leaving the issuer or intermediary’s website and the information that follows is not the issuer’s or intermediary’s.<sup>100</sup>

In addition, the use of clear and prominent disclaimers of responsibility for or endorsement of the hyperlinked information should precede

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<sup>96</sup>*Id.*

<sup>97</sup>*Id.*

<sup>98</sup>Electronic Media Release, notes 41-42 and accompanying text.

<sup>99</sup>*Id.* at II.B.1.b.

<sup>100</sup>*Id.*

or accompany access to the hyperlinked information. Confusion can also result from framing or inclining of information because such techniques allow investors to view both the issuer's site and the hyperlinked site contemporaneously.<sup>101</sup> In the end, however, disclaimers alone will not insulate an issuer from responsibility for information made available to investors whether by hyperlink or otherwise if the total context supports adoption.<sup>102</sup>

An issuer may include the website address (the uniform resource locator or "URL") of the SEC's website or its own website without these websites being considered part of the issuer's prospectus provided the issuer: (1) takes steps to ensure that the URL is inactive (that is, that an investor cannot reach the website by clicking on the address included in the prospectus); and (2) includes a statement to the effect that the URL is an inactive textual reference.<sup>103</sup>

- (3) [Manner of Presentation of Hyperlinked Information](#). The Electronic Media Release suggested that if an issuer or financial intermediary uses hyperlinks to direct visitors to particular information, or changes hyperlinks from time to time depending on the specific information included on the third party's site, selective use of the hyperlink would support adoption.<sup>104</sup> Similarly, formatting the hyperlink to focus visitors' attention to specific information may result in adoption.<sup>105</sup>

(B) ["Entanglement."](#)

Although the SEC views the "entanglement" theory as overlapping the adoption theory, the Electronic Media Release chose not to discuss application of the "entanglement" theory to hyperlinked information on third party websites.<sup>106</sup>

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<sup>101</sup>*Id.*

<sup>102</sup>*Id.*

<sup>103</sup>*Id.*, note 41.

<sup>104</sup>*Id.* at II.B.1.c.

<sup>105</sup>The National Association of Securities Dealers, Inc. (the "NASD") has taken the position that NASD members will not be responsible for the content and filing of material contained in a third-party hyperlink if the link is ongoing, i.e., continuously available and the content of the site, as well as responsibility for updating or changing it, is outside the member company's control or if the link is to general reference and educational material, so long as the linked site does not refer to the member. Letter from T. Selmon, NASD to Craig Tyle, General Counsel, Investment Company Institute (Nov. 11, 1997).

<sup>106</sup>Electronic Media Release, II.B.1.A., note 55.

The entanglement theory relates primarily to research reports; the First Interpretive Release had taken the position that, by posting a research report on its website, or hyperlinking to it, an issuer would risk entangling itself with or adopting the report and having the statements in the report attributed to it for liability purposes.<sup>107</sup> An issuer that has entangled itself “[by placing] its imprimatur, expressly or impliedly, on the [report],” will be alleged to have adopted the statements in the report as its own and, thus, may be liable under Rule 10b-5 under the Exchange Act for any statement in the report that is false or misleading.<sup>108</sup> To date, there is no bright line test as to what constitutes entanglement of a type that will justify attribution of an analyst’s statements to a company. However, an issuer should avoid such actions as providing information to an analyst that the analyst uses in its report, distributing the analyst’s report or editing or approving its final version.<sup>109</sup>

(C) [Free-Riding.](#)

The Electronic Media Release also clarifies that the posting of information on a website in close proximity to a prospectus, without more, does not constitute impermissible “free writing.” An issuer’s website content must be examined in its entirety to determine whether it contains “free writing,” without regard to whether, or where on the website, the prospectus is posted.<sup>110</sup> The issuer also has the same duty as it would through paper delivery to update the preliminary prospectus with any material changes and provide sufficient notice to potential investors of the update.<sup>111</sup>

e. [“Gun-Jumping,” Nonstatutory Prospectuses and Hyperlinks.](#)

As noted above, the Electronic Media Release points out that an issuer’s research report may also create gun-jumping or nonstatutory prospectus issues if the issuer is preparing to offer or in the process of offering securities of

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<sup>107</sup>See note 65, *infra*.

<sup>108</sup>This language first appeared in *Elkind v. Liggett & Myers*, 635 F.2d 156, 163 (2d Cir. 1980). There, the court held that Liggett had not entangled itself in the preparation of the analysts’ reports in question to a degree that would make the reports attributable to Liggett. While Liggett had reviewed and commented upon the reports, it had not commented on earnings forecasts nor leave inaccuracies uncorrected. See discussion of entanglement cases in Eileen S. Ewing, *Fraud on the Cybermarket: Liability for Hyperlinked Misinformation Under Rule 10b-6*, 56 BUS. LAW 375, 384-86 (2000).

<sup>109</sup>See Linda Quinn and Otilie Jarmel, *Securities Regulation and the Use of Electronic Media – Year 2000*, in THE INTERNET AGE: WHAT SECURITIES LAWYERS NEED TO KNOW TO SURVIVE (PLI 2000), 70.

<sup>110</sup>*Id.*, note 45 and accompanying text.

<sup>111</sup>*Id.*, note 6, Example 9.

the same class. The research may be viewed as a solicitation of an offer to buy the securities which may be made only after the registration statement is filed. During the waiting period, an issuer may make offers only by means of a preliminary prospectus; the research could constitute a written offer of the securities outside the prospectus. Perhaps the most crucial activity permitted during the waiting period that has been impacted the most by the use of electronic media has been the roadshow, discussed in more detail below.

f. [Use of Graphics on Online Prospectuses.](#)

One of the positive results of the First Interpretive Release is the ability of an issuer to include graphics, video and audio information within an electronic prospectus.<sup>112</sup> Graphic demonstrations of business systems, product distribution channels, or manufacturing facilities are among the items that may be included in a prospectus posted on a website or in video displays in a video-based prospectus or a CD-ROM. Streaming audio and video and other emerging technologies give promise of electronic disclosure providing a better and more comprehensive picture of a business's operations and components than a conventional paper-based prospectus.

If an issuer cannot practically include an element such as a video clip in its printed prospectus, the SEC has acknowledged that the issuer is not required to prepare a narrative summary of the electronic disclosure in order to achieve equivalent disclosure in the paper and electronic versions of its prospectus.<sup>113</sup> Nonetheless, the SEC made clear that, whenever more than one version of a prospectus is made available to investors, "each version must contain all information required by, and otherwise comply with, the requirements of the applicable form and other provisions of the federal securities laws."<sup>114</sup> The burden is on the issuer to ensure that each version of the prospectus meets the requirements of the Securities Act, and the issuer must satisfy itself that any information omitted from the paper version does not constitute a material omission.<sup>115</sup>

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<sup>112</sup>First Interpretive Release, example 13.

<sup>113</sup>Electronic Media Release, Section I.B.1; Intermediary Release, example 7. The SEC's First Interpretive Release had originally proposed requiring that a paper version of a prospectus include a fair and accurate description or transcript of any graphic, video or audio information included in the electronic version.

<sup>114</sup>Electronic Media Release at Section I.B.1.

<sup>115</sup>An issuer using two versions of a prospectus would be required to file both versions with the SEC pursuant to Rule 424 or Rule 497 under the Securities Act. 17 C.F.R. 230.424 and 230.497. As an alternative, the issuer may file only the paper-based prospectus together with a fair and accurate description of any omitted material. May Technical Release, at n.43.

Notwithstanding the foregoing releases, the SEC's EDGAR rules have continued to require that any video, audio or graphic presentations that cannot be filed on the EDGAR system must be summarized in narrative form.<sup>116</sup> The SEC in 1999 amended its EDGAR rules to permit filings in HyperText Markup Language (HTML).<sup>117</sup>

g. [Wit Capital IPO Innovations.](#)

Wit Capital Corp. in 1999 received a significant no-action letter from the SEC confirming the propriety of certain procedures it used in the public offering of securities over the Internet.<sup>118</sup> Wit requested confirmation that its during the "waiting" period, customers could, in a window period beginning up to 48 hours prior to expected effectiveness of a registration statement, receive reconfirmation from a customer of that customer's previous conditional offer for shares in the offering. Wit Capital also requested confirmation that it could require a new customer to fund its account prior to effectiveness, in accordance with Wit's generally applied minimum for account opening, and not be in violation of Section 5(a) of the Securities Act (by having "sold" the securities prior to the effectiveness of the registration statement).

In its requesting letter, Wit described its modified first come, first served system for allocating shares among customers in public offerings. Thus, if a customer places a conditional offer shortly after the preliminary prospectus becomes available, several weeks may elapse before the offering is actually priced and sold. Wit evolved a procedure that employs a series of e-mails to its customers to explain the mechanics of the offering and to reconfirm their orders.

In seeking SEC's concurrence that the materials sent by Wit to the customers relating to account opening and the like did not constitute illegal prospectuses in violation of Section 5(b)(1) of the Securities Act, Wit stressed that the website on which the communications reside were a sort of "cul de sac" that limited the navigational tools within the site. There are no hyperlinks out of the cul de sac to the remainder of the web site. Thus, to navigate outside the cul de sac, the viewer had to use the navigational tools of the browser, for example, clicking the back button or typing in a new URL or choosing a bookmark. Inside the cul de sac, the only selling documents that would be found are Rule 134

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<sup>116</sup>Rule 304 of Regulation S-T, which governs the electronic submission of electronic materials to the SEC, has, since its adoption, required issuers to provide a fair and accurate description of omitted materials.

<sup>117</sup>SEC Release No. 33-7684 (May 17, 1999).

<sup>118</sup>*Wit Capital Corp.*, SEC No-action Letter (July 14, 1999).

compliant, permissible free writing or the preliminary prospectus. The SEC agreed that Wit's communications related to operating procedures and did not provide information regarding either the issuer or the particular offering, hence did not violate Section 5(a).

The SEC agreed that a customer can be firmly committed to buying in a public offering prior to the effective date of a registration statement, and in expanding the time window in which customers that interact with their broker-dealer through the Internet, can legally "reconfirm" their offer to purchase. The SEC noted that it understood Wit Capital would not affirmatively seek a customer's reconfirmation of his or her pre-effective conditional offer to buy following Post-effective pricing of the offering under SEC Rule 1130A.<sup>119</sup>

h. ["Roadshows" Over the Internet During the Waiting Period.](#)

Roadshows have traditionally preceded underwritten public offerings. The typical roadshow involves presentations made by the issuer and its underwriters to large investors, institutions and analysts. In the presentations, the issuer's management and the underwriters explain the issuer's business and industry as well as the offerings and respond to questions. The roadshow is conducted between the filing of a registration statement with the SEC and the time the registration becomes effective.

The Internet raised several new kinds of roadshow issues. The Securities Act prohibits the transmission of any "prospectus" relating to a security being publicly offered unless it is the same preliminary prospectus on file with the SEC.<sup>120</sup> "Prospectus" is broadly defined in the Securities Act to include any "prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."<sup>121</sup> Accordingly, no written material can be distributed in a traditional "oral" roadshow other than copies of the preliminary prospectus.

The question first arose whether an electronic "roadshow" is like a written, radio or television communication, and hence an impermissible "prospectus" under the Securities Act. Through several no-action letters, the SEC carved out an interpretation of "prospectus" that differentiated virtual roadshows from radio and television and thereby allows them to be legally conducted on the

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<sup>119</sup>*Id.*

<sup>120</sup>Section 5(b) of the Securities Act prohibits use of any "prospectus" that does not meet the requirements of Section 10 of the Securities Act.

<sup>121</sup>Securities Act Section 2(11), 15 U.S.C. §77b(11).

Internet. First, in March 1997, the SEC agreed to take no action against closed-circuit video roadshows, so long as they were transmitted solely to subscribers who consist principally of registered broker-dealers and investment advisors and all of whom would receive a copy of the preliminary prospectus before receiving the video transmission.<sup>122</sup> In so doing, SEC agreed with the position that because no *written* material was to be generated in the transmission, only pictures and oral presentations, no “prospectus” would be involved.

The SEC used the same rationale in September, 1997 to allow public offering roadshows by Internet.<sup>123</sup> The SEC agreed that such a “virtual” roadshow would not constitute a Securities Act “prospectus” if the following format was followed:

(1) A Web site for roadshows regarding public offerings would be established, with a posted index of those available for viewing by qualified investors and by the underwriting investment banks. The roadshows would be indexed by offering company, underwriter and industry classification.

(2) To view an online roadshow, a qualified investor would be required to contact an institutional salesman or the syndicate department at one of the underwriters. The qualified investors would be typical of those customarily invited to attend live roadshows (*e.g.*, registered broker/dealers and investment advisers). An access code would be required to view the roadshow on the Internet, a log would be maintained of who specifically received the access code. The access code for each roadshow is changed each day and each qualified investor will be allowed to view a roadshow one day only.

(3) The Internet roadshow would be exactly the same as the live show. The live roadshow would be filmed in its entirety, including the filming of all questions and answers. The Internet version of the roadshow would present the charts and oral presentation at a similar speed as the live roadshow.<sup>124</sup>

(4) A large and obvious button reading “PRELIMINARY PROSPECTUS” would be continuously displayed throughout the roadshow. A viewer would simply click on the button to access the preliminary prospectus on file with the Commission to view it in its entirety.

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<sup>122</sup>*Private Financial Network*, SEC No-action letter (March 12, 1997).

<sup>123</sup>*Net Roadshow, Inc.*, SEC No-action Letter (Sept. 8, 1997).

<sup>124</sup>If information were to change between the time the road show is filmed and throughout the period the road show is available on the website, the display would include a periodic crawl providing a synopsis of such changes. The crawl would also advise the viewer to contact the appropriate institutional salesman for further information about such changes.

(5) Before accessing the roadshow, a potential viewer would be required to agree to a broad disclaimer and statement to the effect that copying, downloading or distribution of the material is not permitted, that the roadshow does not constitute a prospectus and that there was no any regulatory approval of the securities being offered.

(6) The viewer would be informed by a periodic crawl across the screen or by prominent text of the importance of viewing the filed prospectus, which is available by clicking a button the screen.

Other no-action letters followed. In late 1997, the online investment news service Bloomberg also gained SEC permission for Internet roadshows.<sup>125</sup> Bloomberg's roadshow differed from that of Net Roadshow in its simultaneous broadcast: the viewer could participate in the Bloomberg roadshow presentation on an interactive basis by sending questions which are fielded by an online monitor who can present the question to representatives of the issuer. This moved a step beyond the rebroadcast that occurs in earlier online roadshows. In addition, the Bloomberg roadshow allowed the preliminary prospectus to be called up on the viewer's screen or downloaded at any time.

In 1999, the number of persons eligible to attend electronic roadshows was expanded by a no-action letter which allowed Charles Schwab & Co., Inc. to make its electronic roadshow available to all of its clients to whom it offers participation in IPOs.<sup>126</sup> Substantially all of these are individual investors who buy at retail. Schwab's requesting letter stated that Schwab would provide password protected access to its "Gold" accounts, which represent less than 20% of its 6.3 million customers, as well as to its not more than 10,000 independent investment advisers clients. Schwab's requesting letter argued that advances in information technology should empower investors by making appropriate information accessible as widely, as quickly and as efficiently s possible. It contended that "road show information should not be reserved for a select few, but should be more broadly available to investors who are considering participation in a given offering, regardless of their individual size or market power."<sup>127</sup> Schwab stressed at the same time that, to qualify for the Gold level, a client must have a trading history of at least 24 trades per year or assets of at least \$500,000 equity in

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<sup>125</sup>*Bloomberg, L.P.*, SEC No-action Letter (Dec. 1, 1997). See also *Thompson Financial Services, Inc.*, SEC No-action Letter (Sept. 4, 1998) and *Activate.net Corporation*, SEC No-action letter (Sept. 21, 1999), which allowed roadshows on a basis similar to that in *Bloomberg* and *Net Roadshow*, restricted to institutions or others typically invited to roadshows.

<sup>126</sup>*Charles Schwab & Co, Inc.*, SEC No-action letter (Nov. 15, 1999).

<sup>127</sup>*Id.*

household investment positions. Thus, while it did not propose to make road shows generally available, Schwab urged “that it is not appropriate to make artificial distinctions that keep relevant information hidden from retail investors who might participate in the offering, while it is made available to all others who might buy in the offering.”<sup>128</sup>

As part of its no-action request Schwab undertook the following obligations:

(1) The roadshows would be communicated over the Internet only with respect to initial public offerings of securities and only after the relevant registration statement has been filed and a preliminary prospectus is being distributed.

(2) A preliminary prospectus would be available to all those who are able to view the roadshow, and a button will be available on the screen displaying the roadshow, enabling the investor to view, print or download the preliminary prospectus. A legend will be provided including language substantially to the following effect:

“An offering of the securities of this issuer is in process, but is made only by the prospectus. That prospectus is included in a registration statement that has been filed with the Securities and Exchange Commission but has not yet become effective. We urge you to review that prospectus carefully before making any investment decision. To obtain it, double-click on the ‘prospectus’ icon appearing on the screen.”

“These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This communication shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any State in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such State. The Securities and Exchange Commission does not endorse this offering, nor does any state regulatory authority.”

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<sup>128</sup>*Id.*

(3) As part of the log-in process there would be a representation that the viewer, by electing to view the transmission, agrees not to re-transmit the content of the transmission, or otherwise make it available, to others who are not eligible to view it under the criteria identified in this letter.

(4) If Schwab were to present its roadshows through arrangements with third-party vendors who have already adopted procedural safeguards satisfactory to the SEC staff under existing no-action precedent relating to electronic roadshows, Schwab abide by (and be subject to) those same safeguards (other than limitations on the qualifications of persons entitled to view the presentation).

(5) To the extent Schwab could influence the presentation (as, for example, the lead manager of a public offering typically can), Schwab would also seek to ensure that the information presented is consistent with that contained in the prospectus.

(6) If Schwab were to present the roadshow itself, then Schwab said it would comply with the following guidelines.

(a) It would ensure that the roadshow transmitted over the Internet is a “live” or recorded transmission of a roadshow that is or was actually presented live before a physically present audience of persons who are underwriting participants, eligible investors, or both, and who have the ability to ask questions and receive responses.

(b) It would ensure that the entire presentation, with questions and answers, is included in the Internet transmission.

(c) It would limit access, through assignment of a password, to any electronic roadshow that it transmits, to persons or entities that have Schwab Signature Services™ accounts at the Gold level or higher, or are Independent Investment Advisers.

(d) It would limit viewings by recipients in a manner heretofore described in a no-action requests that received a favorable response, i.e., two viewings per subscriber, viewings on one day only, or unlimited viewings within a single 24-hour period.

(e) It would give only a single password to any one account or Independent Investment Adviser.

(f) It would transmit only one version of a particular IPO roadshow during the waiting period for that IPO, and require any recipient to represent that he or she would not, copy, download or retransmit the contents to others not eligible to view it.

In granting no-action treatment to Schwab, the SEC's staff emphasized that its position extended only to registered IPOs with a firm commitment underwriting in which Schwab is a member of the underwriting syndicate or selling group. The staff also noted that Schwab would be responsible under the Securities Act for the content of any roadshow that it transmitted, regardless of whether the issuer or another broker-dealer participating in the distribution is primarily responsible for the roadshow content. The no-action intentionally did not address the question whether Internet-based or other electronic communications should be treated as "written" or "oral" for purposes of Securities Act regulations, asserting that the staff's position rested on policy considerations alone.

On February 9, 2000, the SEC issued a further clarification of the first Schwab letter.<sup>129</sup> It stated that the November 1999 letter applied only where: (1) material information intended to be included in another presentation of the roadshow is not excluded; (2) only a single version of the roadshow is used for electronic transmission; and (3) the roadshow is consistent with the content of the statutory prospectus. The letter reflects an SEC concern that wide-spread dissemination of roadshows to retail customers as well as institutions would exacerbate issues of selective disclosure, since retail customers might end up seeing an Internet roadshow different from the same roadshow shown to institutional investors.

Although in 1998, one venture firm was reported as being prepared to seek a no-action letter from the SEC that would allow all retail investors access to roadshows via the Internet,<sup>130</sup> that has not occurred. Accordingly, the full democratization of roadshows is yet to come. The ready availability of roadshows, together with increased availability of financial information, analysis and tools to the individual investor, raise the question whether it makes regulatory sense to continue to deny the individual investor the ability to "attend" a virtual roadshow. SEC Chairman Arthur Levitt, Jr. has observed that "technology is a powerful tool in helping establish a 'level playing field' for all investors, large and

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<sup>129</sup>Charles Schwab & Co., Inc., SEC No-Action Letter, 2000 SEC No-Act, LEXIS 194 (Feb. 9, 2000).

<sup>130</sup>*Direct IPO Eyes Retail WebRoad.Shows*, INTERNET COMPLIANCE ALERT (Mar. 9, 1998), 1.

small.”<sup>131</sup> Assuming the Chairman is correct, there is no reason to restrict the type of information available at a roadshow—which consists of more recent information and projections not contained in the prospectus—to more affluent and powerful investors.

In light of developments in 1999 and 2000, it may be significant that in the Electronic Media Release the SEC conceded that it has “not extended the same flexible treatment to securities offerings aimed at raising capital” as it has to cash tender offers, mergers and exchange offers.<sup>132</sup> The SEC said it is “considering separately” the liberalization of communications by issuers and other market participants, and “also considering separately the use of road shows in the capital raising context.”<sup>133</sup> Certainly the theme of new SEC Regulation FD, which is to afford equal access to material information for average investors as well as institutions, would argue in favor of broadening roadshow access.<sup>134</sup>

### C. Different Types of Internet IPOs.

#### 1. Direct Public Offerings (“DPOs”).

A DPO involves an offering without a broker-dealer intermediary. Instead, the issuer sells its own securities directly to investors in what is, in effect, a “best-efforts” offering. The DPO sometimes will involve an escrow into which the proceeds from a minimum level of sales must be deposited in order for any funds to be released to the issuer. Recently, DPOs have been conducted without requirement for a minimum level of sales before the issuer obtains proceeds. Direct offerings have been around for many years before the Internet, although only a relatively small number were made. The World Wide Web is changing the DPO landscape because it enables the issuer to access so many potential investors so rapidly. Dozens of sites for DPOs on the World Wide Web—most of them generated since mid-1996—demonstrate the online approach to corporate finance.

#### a. Formats Used for DPOs.

Several formats are used in DPOs, depending upon the amount of money the issuer intends to raise. Most DPOs on the web have used either (1) SEC Form 1-A promulgated under SEC Reg. A, which provides an exemption

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<sup>131</sup>*Investor Protection in the Age of Technology*, Remarks by Chmn. Arthur Levitt Jr., SEC, Salt Lake City, Utah (Mar. 6, 1998) (available at [www.sec.gov/news/speeches/spch205.txt](http://www.sec.gov/news/speeches/spch205.txt)).

<sup>132</sup>Electronic Media Release, I., note 5 and accompanying text.

<sup>133</sup>*Id.*, note 6 and accompanying text.

<sup>134</sup>SEC Release No. 33-7881 (Aug. 15, 2000) contains the rules that make up Regulation FD, as well as a discussion of the background for the rules.

from full-blown registration for stock offerings that do not exceed \$5 million, (2) state qualification on blue-sky form U-7, available for offerings not over \$1 million and exempt from SEC registration by virtue of SEC Rule 504, or (3) SEC Form SB-2.

Form U-7 has been approved by the North American Securities Administrators Association (“NASAA”) and is called the Small Corporate Offerings Registration or “SCOR” form. It is a 50-question form designed to be understood by the average lay person and is accepted in every state except Alabama, Delaware, Hawaii and Nebraska. Offerings made on Form U-7 are exempt from SEC registration by virtue of SEC Rule 504 under Regulation D, which exempts offerings directly by issuers (but not resales) of not more than \$1 million.<sup>135</sup>

In 1999 the SEC adopted changes to Rule 504.<sup>136</sup> Rule 504(b)(1) now states that in order for an issuer to qualify for the exemption, “offers and sales must satisfy the terms and conditions” of SEC Rules 501 and 502(a), (c) and (d). In other words, Rule 504 offerings may not be accompanied by general advertising or general solicitation and the securities sold in those offerings are restricted within the meaning of SEC Rule 144(a)(3). However, in two circumstances, general solicitation is permitted and “freely tradable” securities may be issued.

The first circumstance is where the issuer registers the offering under a state law that requires the public filing and delivery of a disclosure document to investors prior to sale and makes offers and sales in accordance with those state provisions. The disclosure document contemplated by this exception must be publicly available at the state level. According to the SEC, the “disclosure document must provide substantive disclosure to investors, including the business and financial condition of the issuer (including financial statements), the risks of the offering, a description of the securities, and the plan of distribution.”<sup>137</sup>

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<sup>135</sup>It should be noted that Form U-7, which is either formally adopted or otherwise accepted by 45 states, cannot be used for firm commitment underwritings, because they involve resales, i.e., the underwriters purchase the securities from the issuer and immediately resell to the public.

<sup>136</sup>SEC Release No. 33-7644 (May 21, 1998) (the “Rule 504 Release”).

<sup>137</sup>*Id.* at n.36. The Commission noted that the issuer could provide the information required in a Form U-7 to satisfy this requirement. In states that have adopted the Small Corporate Offering Registration (“SCOR”) Review Statement of Policy, information on an issuer is available to investors through Form U-7. The Form U-7 contains a series of 50 very detailed questions on the issuer’s business, intended use of proceeds, management, principal stockholders, and plan of distribution. In addition, the issuer must file historical financial statements prepared in accordance with generally accepted accounting principles in the United States. Form U-7 has been either formally adopted or recognized and accepted by 45 states. *Id.* at n.37.

If the issuer wishes to make a public offering in a state without a provision in its law requiring public filing and delivery of a disclosure document before sale, (*e.g.*, New York), the transactions must be registered in another state with such a provision and the disclosure document filed in that state must be delivered to all purchasers before sale in *both* states. Thus, the Rule 504 Release states:

“If any state that the issuer intends to make sales in does not provide for the registration or the public filing or delivery of a disclosure document to investors before sale, then in order to be able to issue freely tradable securities and to engage in public solicitation or public advertising, the issuer must register in at least one state with such a procedure. The disclosure document must be delivered before sale to all purchasers, including purchasers in the states that have no registration and delivery procedure. The process does not allow using one state’s prospectus in another state where the second state provides a conforming procedure.”<sup>138</sup>

The second circumstance where an issuer in a Rule 504 offering can issue freely tradable securities is where the transaction is effected under a state law exemption that permits general solicitation and general advertising so long as sales are made only to “accredited investors,” within the meaning of SEC Rule 501(a).<sup>139</sup>

The state also imposes various requirements on use of U-7 for offers within their jurisdiction.<sup>140</sup> For instance, some states require that the issuer have equity capital of a certain percentage of the total capital being raised. Most states limit the costs and expenses of originating the capital and require audited financial statements for offerings over \$500,000. The SCOR form can also be used as part

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<sup>138</sup>*Id.* at n.37.

<sup>139</sup>The SEC noted that generally, securities sold pursuant to such a state law exemption may not be freely transferred under state law:

“The Model Accredited Investor Exemption provides that any resale of a security sold in reliance of the exemption within 12 months of sale will be presumed to be with a view to distribution and not for investment, a requirement of the exemption, except for limited circumstances. With respect to general solicitation and advertising, the Model Accredited Investor Exemption specifies that only a tombstone ad may be used; however, a few states have no restriction on general solicitation and advertising so long as sales are only made to accredited investors.”

*Id.* at n.38.

<sup>140</sup>For discussion of jurisdictional issues related to state blue-sky regulation, see Subsection IV.D, *infra*.

of a Reg. A filing, and some listing services on the Web require that listing companies which file under Reg. A incorporate the SCOR form.<sup>141</sup>

An issuer that wants to raise over \$1 million cannot use the SCOR form. If it intends to raise \$5 million or less within 12 months it can use Form 1-A under Reg. A. If the issuer intends to raise over \$5 million, it must file a full registration on the applicable SEC form. This is usually Form S-1, unless the issuer qualifies as a “Small Business Issuer” to use Form SB-2 or SB-1. To be a Small Business Issuer, it must (1) have revenues less than \$25 million in the last fiscal year and (2) have a public float having a market value of less than \$25 million in the last fiscal year, as well as certain other criteria.<sup>142</sup>

b. Examples of DPOs.

An early DPO made under the Reg. A exemption was located on the Web site of “IPO DataSystems” ([www.ipodata.com/dpo.html](http://www.ipodata.com/dpo.html)). The issuer, “Interactive Holdings Corporation” ([www.thevine.com/ihchome.htm](http://www.thevine.com/ihchome.htm)), sought to sell its own stock directly by allowing the downloading of an offering circular and a subscription agreement. The offering circular on the Web site, however, was not the “official offering circular” filed with the SEC. That document had to be obtained by request made via fax, phone, e-mail or regular mail. Other DPO sites, such as that for “Pyromid Inc.,” allowed the offering document to be viewed online and downloaded by the viewer ([www.pyromid.com/pyromid/offcirc.html](http://www.pyromid.com/pyromid/offcirc.html)). Pyromid made what it called “technologically advanced” portable outdoor cooking systems for campers, hikers and other outdoor enthusiasts, and its Reg. A offering circular covered a minimum-maximum best efforts offering between about \$3 million to \$5 million.

Another site that allowed direct downloading of a prospectus was that of Dechtar Direct, Inc. (“DDI” at [www.dechtar.com](http://www.dechtar.com)). DDI’s prospectus, placed on the Web in February 1997, stated that it was the “largest advertising company in North America specializing in the adult entertainment and adult mail-order industries.” Among its services were providing catalog lead generation and response services. DDI’s offering was the first Web DPO to combine a secondary offering of already outstanding shares by selling stockholders with new shares offered by the issuer. Its offering was unusual at the time, because it was done by means of a registration statement on SEC Form SB-2, rather than using one of the exemptions such as Reg. A or Form U-7. Form SB-2 had to be used because the foregoing exemptions are not available for secondary sales by existing

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<sup>141</sup>See discussion of *Angel Capital Electronic Network*, notes 176-177, *infra* and accompanying text.

<sup>142</sup>SEC Rule 405, Regulation S-B, Item 10(a).

stockholders.<sup>143</sup> An example of an issuer that has more recently used Form SB-2 is California Molecular Electronics Corporation ([www.calmec.com/DPO.htm](http://www.calmec.com/DPO.htm)). The San Jose issuer filed with the SEC and its registration statement became effective on February 7, 2000. The company offered one million shares at \$6.00 each. Through February 28, 2001, when it terminated the offering, the company had sold 120,239 of its shares.<sup>144</sup>

A Web-posted DPO must take steps to avoid problems under state blue-sky laws. If an offering document can be read and downloaded directly at the site, the issuer should install a “screen” to prevent making offers to residents of those states in which the offering has not been qualified. This procedure allows the offering to meet the states’ jurisdictional blue-sky exemptions discussed below.<sup>145</sup> At some sites, for example, the viewer is presented with a screen that lists all 50 states as well as various foreign countries. The viewer first clicks in the state of residence from this list, and access to the prospectus and subscription material is only granted if the offering has been qualified in that state.

One of the early most ambitious DPOs was the \$100 million offering of Technology Funding Venture Capital Fund VI, LLC (“Tech Funding”; website at [www.techfunding.com](http://www.techfunding.com)). Tech Funding also linked its site to the Direct Stock Market, one of the interface sites between DPO issuers and investors discussed below and its prospectus located on the SEC’s EDGAR database ([www.sec.gov/Archives/edgar/](http://www.sec.gov/Archives/edgar/)). Tech Funding filed on Form N-2, using a wholly-owned broker-dealer subsidiary to assist in the offering without being paid any sales commission, and its registration became effective in December 1997. Unlike most other DPO issuers, Tech Funding was not seeking to develop a public or secondary market for its shares. Instead, share transfer was to be subject to the control of the Fund managers.

Tech Funding’s offering was notable for dealing with the question of selling shares on credit. Normally, sales of securities which do not contemplate prompt payment within three business days are governed by the SEC’s margin restrictions. Five months after its offering was first posted, Tech Funding’s investment manager and sole distributor received an exemptive order from the

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<sup>143</sup>Real Goods Trading Corp. subsequently filed an SB-2 in the summer of 1997 which also included a secondary offering by the controlling shareholder. SEC Registration No. 33-30505.

<sup>144</sup>Part II, Item 6 to the company’s 10-KSB filed with the SEC on April 2, 2001.

<sup>145</sup>See Subsections IV.D and IV.G.3, *infra*.

SEC to accept payment for its fund shares over the Internet by means of credit card.<sup>146</sup>

The staff approval stressed that the credit card purchases would be allowed only through the Internet, a prominent warning would be displayed on the Fund's Web site to dissuade investors from carrying a balance on their cards as a result of a purchase of the Fund's shares and to show how related interest costs could exceed any increase in share value, and the distributor's employees would not be compensated on the basis of shares sold. As of January, 2001, a visit to the Tech Funding site showed that it had never sold more than a little over \$400,000 in its shares, and was unlikely to ever reach its maximum. The Fund's third quarter report for the period ending September 30, 2000 said the Board of Directors was considering offering the investors a refund of their original capital contribution plus interest.<sup>147</sup> The Fund had invested in five emerging companies, one of which had gone public.

c. [Giving Away Free Stock on the Net.](#)

A unique by-product of the Web is the offer of free securities to online viewers. One of the first of the breed was that of Travelzoo.com. This online travel service, located in the Bahamas, began giving away its stock in the summer of 1998. Travelzoo limited visitors to its site to no more than three free shares each, which shares are held electronically in the Bahamas.<sup>148</sup> Travelzoo.com claimed that it will benefit from giving away free stock, because it will attract so many "hits," or visitors, that advertisers and others will find its site to be an attractive venue. Travelzoo.com was followed by other free stock programs including E-Compare. In January, 1999 the SEC in a no-action letter took the rather strained position that viewers, merely by clicking on to the issuer's Web site, were passing "value," and hence consideration, to the issuer; accordingly, the staff said such giveaways had to be registered under the Securities Act.<sup>149</sup> The reasoning of the staff is somewhat debatable, since a netsurfer's time and effort is minimal in visiting sites. Certainly the staff's position violates the "no harm, no foul" principle. The greater problem for "giveaway" issuers is how to satisfy the

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<sup>146</sup>Technology Funding Securities Corp., SEC No-action Letter (May 20, 1998).

<sup>147</sup>Third Quarter Report of Technology Funding Venture Capital Fund VI, LLC at [www.techfunding.com/reports/vc6\\_q3\\_00.html](http://www.techfunding.com/reports/vc6_q3_00.html). The Board was also considering, as an alternative, refunding the investors' proportionate shares of the Funds' net asset value. *Id.*

<sup>148</sup>D. Fost, *Internet Firm Giving Away Its Stock*, S.F. CHRON. (July 29, 1998), B-1.

<sup>149</sup>See the following two No-action Letters: *Vanderkam v. Sanders*, (Jan. 27, 1999) and *Simplystocks.com* (Feb. 4, 1999). A different situation was presented by *American Brewing Co.*, SEC No-action Letter (Jan. 27, 1999), because the "free" shares actually required purchase of the issuer's product.

corporate law in those states that require shares to be issued for “consideration.” The shares might be illegally issued in such jurisdictions (viz.: Delaware) and the directors exposed to shareholder action.<sup>150</sup>

The SEC in July, 1999, filed four separate administrative consent judgments involving purportedly free stock on the Internet. Each of the factual situations went well beyond a simple online offering of stock. However, the SEC used each proceeding to articulate a new and unnecessary doctrine on “gifts” and to suggest that any stock giveaway will be deemed a “sale” under the Securities Act.<sup>151</sup>

Two of the proceedings involved fraudulent schemes that integrated free stock offerings with cash offerings of securities or sales of services. In one, the issuer was not even incorporated and had no authorized shares, nor any offices, employees, contractors or business plans.<sup>152</sup> Despite the fact that all four proceedings involved fact patterns that violated long-established doctrines under the Securities Act, the SEC in each one needlessly articulated a new and confusing interpretation of when a “gift” becomes “sale,” stating that:

“A gift of stock is a ‘sale’ within the meaning of the Securities Act when the purpose of the ‘gift’ is to advance the donor’s economic objectives rather than to make a gift for simple reasons of generosity.”<sup>153</sup>

The ambiguous phrase, “simple reasons of generosity,” had not been previously used in any reported securities case or SEC release. The phrase leaves it unclear whether a donor’s “economic objectives” can play no role or only a subordinate role in the gift of stock.

The incongruity of the SEC’s position was further exemplified in 1999 by staff’s processing of the registration statement filed by Younftwork Corp. on Form SB-2. This issuer proposed to distribute the first 250,00 of one million shares of \$.0001 par value Class A common “at no cost” to each of the first 250,000 members of its consumer network.<sup>154</sup> Members of the network would be eligible for rates on products and services purchased through the issuer’s site. Another 750,000 shares would be distributed to members based on the number of

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<sup>150</sup>See Denis Rice, *Free Stock on the Internet Is Not a Menace*, 13 INSIGHTS No. 9 (Oct. 1999), 8, 9.

<sup>151</sup>*Id.* at 11.

<sup>152</sup>*Id.* at 11.

<sup>153</sup>*Id.*

<sup>154</sup>SEC File No. 333-71949. The registration became effective on July 13, 1999.

other members that they directly or indirectly recruited. For purposes of computing the filing fees, the SEC put a zero value on the free shares, which is directly at odds with the theory of its no-action position. Even more inconsistent was the SEC's processing of the SB-2 registration of DoctorSurf.com, Inc.<sup>155</sup> It registered 25 million shares of common stock which it proposed to give away in 100 share lots to the first 350,000 doctors who became members of its website and provided detailed biographical information. The aim of the issuer was to provide a "one stop" web portal for all of a doctor's informational and shopping needs.<sup>156</sup> Regardless of the rather thin underpinning of the SEC's position on the issue, a stock giveaway must take account of that position. A careful practitioner may want to resort to using one of the recognized exemptions, such as SEC Rule 504, unless the "free" shares are to be registered.<sup>157</sup>

d. New Types of Intermediaries.

As exemplified by offerings like California Molecular Electronics Corporation, DPOs have been less than a smashing success on the Web. Some commentators believe that the base must be broadened and the number of households with Internet connection substantially increased in order to support general securities offerings.<sup>158</sup> To the extent "success" in a DPO is defined as reaching the minimum amount of sales required to close escrow and release funds to the issuer, a minority of all DPOs have achieved success. Even fewer have sold the maximum amount of a minimum-maximum range. These results may improve over the longer term as more DPOs are assisted by the new kinds of on-line intermediaries that are springing up on the Web.

One of the new types of financial intermediary is the Web site designed to develop databases of potential investors in new stock offerings which can be linked on site to new DPOs. For example, "Internet Capital Exchange" ([www.inetcapital.com/](http://www.inetcapital.com/)), operated by Internet Capital Corp. ("ICC"), was one of the first Web startups to attempt to connect various DPO issuers with potential investors. To register with ICC's "exchange," a viewer would be required to first fill out a questionnaire giving certain personal information. Completion of the questionnaire would allow access to the "Roadmap to a Direct IPO," which would include a description of SEC forms suitable for public offerings of newer and emerging companies. Upon completing personal registration, the participant would be entitled to be notified by e-mail of new offerings which are legally

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<sup>155</sup>SEC File No. 333-80475.

<sup>156</sup>*Id.* at 12.

<sup>157</sup>*See* [www.doctorsurf.com](http://www.doctorsurf.com).

<sup>158</sup>E. Hubler, *An Ex-Regulator Talks About The Internet*, SEC IND. NEWS (Dec. 2, 1996), 1, 2.

offered in the viewer's state of residence. The Internet Capital Exchange system for secondary trading of already-issued securities was to be based on its bulletin board. Access to the board would permit the participant to find posted sell offers, select one to accept, or post the viewer's own offer to buy.

Internet Capital Exchange initially offered its service without any SEC clearance. It disclaimed on its Web site being a broker/dealer, investment advisor, or being registered with the SEC or any state blue-sky agency, and disclaimed having evaluated or investigated any company listed on the site or endorsing any such company. Nevertheless, it assured its audience that modern technology is creating fantastic opportunities "to realize the American dream of success and independence" and that Internet Capital is "bringing these opportunities directly to you."

The SEC stepped in and informed ICC that it could not operate the bulletin board until it requested a no-action letter, feeling the site would be involved in active solicitation and conducting business as an underwriter.<sup>159</sup> In its subsequent request for a no-action letter from the SEC, ICC specified the conditions which would govern its operations in order to avoid registration as a broker-dealer.<sup>160</sup> The conditions included the following:

(1) ICC would charge only a flat fee, not contingent upon the success of the offering, to issuers to provide a Web site for facilitating the issuer's online securities offering.

(2) ICC's service would be provided for issuers of registered offerings as well as Reg. A and SCOR offerings. ICC would not provide this service for securities to be issued pursuant to Rule 505 or 506 of the Act.

(3) ICC's Web site would support a grouping of individual corporate bulletin board areas or "corporate listings." An individual logged on to the site could elect to visit any corporate bulletin board area where a tombstone, preliminary offering document, or final offering document can be viewed regarding a specific company. Each corporate bulletin board area would remain autonomous and operate separately from all of the other corporate areas; only offerings and information pertaining to that specific corporation would be displayed in its bulletin board area.

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<sup>159</sup>II INTERNET COMPLIANCE ALERT No. 2, 1 at 16 (1998).

<sup>160</sup>*Internet Capital Corp.*, SEC No-action Letter (Dec. 18, 1997, revised Dec. 24, 1997).

(4) “Tombstone” advertisements on the site would meet the requirements of SEC Rule 134, and the red herring prospectus would meet the requirements of SEC Rule 430. Such “tombstone” advertisements and the red herring prospectus would set forth the names of the issuers.

(5) The distribution of the “tombstone” advertisement and the red herring prospectus would be in accordance with the First Interpretive Release.<sup>161</sup> There would be no “hot links” between the Web site and any other corporate marketing information or a corporation’s home page.

(6) The order in which issuers were to be displayed within ICC’s site would be determined by objective criteria (either alphabetically by name of issuer, or sequential by date of listing). A disclaimer will state that the order of presentation in no way constitutes any judgment by ICC as to the merits of a particular offering. The site would link to any “tombstone” advertisement or any red herring prospectus the disclaimers required under SEC Rule 134(b)(1) and (d), respectively.<sup>162</sup>

(7) Once an issuer were to receive notice that its registration is effective, ICC would post the final offering document on its Web site. Only the final offering document will contain the subscription documents necessary to purchase the offered securities.

(8) The Web site would contain a disclaimer that ICC is an underwriter of the securities or is acting as a broker-dealer or agent of the issuer, and in fact would not function as an underwriter or a broker/dealer, but merely act as a delivery mechanism for an issuer.

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<sup>161</sup>See notes 13-38, *supra*, and accompanying text for description of the applicable SEC Securities Act releases.

<sup>162</sup>These state:

“A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. These securities may not be sold, nor may offers be accepted, prior to the time the registration statement becomes effective. This (communications) shall not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of these securities in any state in which such offer, solicitation, or sale would be unlawful prior to registration or qualification under the securities laws of any state.”

\* \* \* \*

“No offer to buy the securities can be accepted and no part of the purchase price can be received until the registration statement has become effective; and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at any time prior to notice of its acceptance given after the effective date. An indication of interest in response to this advertisement will involve no obligation or commitment of any kind.”

(9) ICC would not receive any commission nor take compensation of any kind based on the sale of any securities. Instead, its one-time flat fee (the “Listing Fee”) would cover such items as development of the software, use of the software platform, design and graphics work and technical consulting regarding the listing and access to the ICC system. The Listing Fee would be independent of the number of hits to the Web Site after listing, or success of the offering.

(10) ICC would not receive, transfer, or hold funds or securities, nor provide information of any nature regarding the advisability of buying or selling securities.

(11) A viewer seeking to access ICC’s corporate listing areas would first have to go through a registration process involving disclosure of key information about the viewer and issuance of a selected log-on name and password required for required for further access to the Web site.<sup>163</sup>

(12) Viewers would be given the opportunity to download a prospectus electronically or request that the issuer deliver a printed copy of the prospectus, and ICC would have no contractual liability for improper prospectus delivery. Instructions for sending the proper funds and subscription information to the issuer or its agent will be contained in the prospectus. Subscription agreements would be included in the file delivered with the prospectus. No subscription agreements could be accessed without delivery of a prospectus.

(13) After electronic delivery of a prospectus, ICC would have no further involvement in the transaction, such as negotiations regarding prospective purchases, record keeping of completed transactions or any reporting requirements of the issuer.

(14) ICC’s Web site would be structured so as to preclude any solicitation or viewing of an offering document by persons in states where the securities were not qualified for sale.

Based on the foregoing methods and procedures described, the SEC said it would not require ICC to register as a broker-dealer pursuant to Section 15(b) of the Exchange Act.<sup>164</sup>

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<sup>163</sup>ICC also represented that its site had implemented an additional user registration or validation process which would ensure the proper identity of any individual wishing to access the site.

<sup>164</sup>*Internet Capital Corp.*, SEC No-action Letter (Dec. 18, 1997, revised Dec. 24, 1997). *Also see* discussion of blue-sky safe harbor for Web offerings in subsection IV.G.3., *infra*.

The SEC specifically expressed no view on whether ICC would be acting as an “underwriter” within the meaning of the Securities Act nor whether the prospectus delivery procedures described in ICC’s letter satisfy the standards previously articulated by the SEC in the October Releases and Release 7288. This refusal to sanction the business plan appears to have eliminated ICC as a serious participant in financings. ICC by mid-1998 was still in beta test on its website and had no DPOs posted. Its bulletin board was likewise still in beta test. The principal product being marketed by ICC-1 at the time was a software program for preparing and conducting DPOs. By the end of 1999, ICC had ceased to function as an entity and its domain name was for sale.

Another firm proposing an even more extensive role in DPOs made over the Internet is First Internet Capital Corp. (“INTERCAP” at [www.1stcap.com](http://www.1stcap.com)). As of early 1998, INTERCAP claimed to offer “a fully integrated range of services necessary for a company to go public over the Internet via a Reg. A offering. Among services it described on its Web site were:

- (1) Conducting initial due diligence.
- (2) Drafting offering materials.
- (3) “Making available at a package price a highly competent securities attorney” to review and file the offering with the SEC, and to provide “follow-up” until the offering is cleared.
- (4) “Making available, at the best price possible, a Big 6 accounting firm” to audit the issuer.
- (5) Providing escrow and stock transfer services of Huntington National Bank “on a negotiated package basis.”
- (6) “Direct access” to INTERCAP’s list of interested investors.
- (7) Promoting and advertising the issuer’s offering over the Internet.

For the foregoing services, INTERCAP said it would receive unspecified cash, a “moderate contingent fee” to be paid from the proceeds of the offering, plus a “small percentage of the company’s stock.”

Because it was to receive contingent compensation for, among other activities, “due diligence” and “promoting and advertising” the offering, INTERCAP would appear to fall within the statutory definition of an underwriter

under the Securities Act.<sup>165</sup> Whether it applied to the SEC for a no-action letter is not known (an online search of posted no-action letters did not locate any for INTERCAP). Indeed, if implemented, INTERCAP's plan could expose itself to possible liability for any failings on the part of attorneys whom it "makes available [to issuers] at a package price." The attorneys themselves in such a structure could encounter sticky professional responsibility and conflict of interest issues under applicable state laws in view of the way they are planned to be brought into the DPO transactions. As of January, 2000 there was no evidence on INTERCAP's site that it actually had closed any financings.

Some Web sites do not profess to be as less proactive and simply provide centralized links to DPO issuers without additional services such as databases of investors. The utility and potential profitability of such sites is dubious, because the linking service offered is narrow, and there are better ways to access DPOs. Few of these limited sites have lasted long with such limited services. For example, in 1996 a viewer could have logged on to "SCORnet" (scor-net.com) to find lists of issuers who filed using Form U-7, SEC Reg. A or who had registered on SEC Form SB-2. "SCORnet" also contained a list of prospectuses of a number of issuers listed by state.

However, in June 1997 SCORnet was merged into "Direct Stock Market Incorporated," with its Web address changed (as of February, 2000, the address is [www.dsm.com](http://www.dsm.com)). Direct Stock Market hosts electronic road shows and seminars (in which "full streaming video and audio" could be presented together with presentations by issuers while taking questions from the audience through a chat window), and lists public and private offerings which are accessible on-line only by registered viewers. Starting in 1998, Direct Stock Market has used "push" technology to send notices of new public and private offerings to its subscribers. Although it has said it had requested a no-action letter from the SEC to allow it to operate an electronic bulletin board for secondary transactions, as of January 2000 no such trading vehicle had been set up on the site.

A number of the companies that initially used the Web to offer their securities directly to the public were in some phase of consumer goods or services, whether beer, health products, or outdoor cooking devices. These kinds of issuers sought to leverage off some built-in "constituency" of consumers who were already familiar with their products and therefore might be receptive to their stock. DPO issuers who start with just a new product or technology, in contrast, have no such preexisting base. The picture is beginning to change with the maturation of Web sites that assist DPOs by developing databases of potential investors whom

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<sup>165</sup>Section 2(11) of the Securities Act.

issuers can solicit. Over time, we can expect to see such investor groups divided and subdivided accordingly to the types of industries they prefer. This will allow more “targeting” in the DPO process.

## 2. Underwritten IPOs.

### a. Evolution of Web-Based Underwritings.

Underwritten offerings using the Web to broaden their reach have been typically filed on SEC Form S-1, S-2 or S-3, and hence been exempt from qualifying under state blue-sky statutes.<sup>166</sup> (However, state qualification is required where the offering is made by means of the Regulation A (“Reg A”) exemption from Securities Act registration or by a “small business issuer” on SEC Forms SB-1 or SB-2.<sup>167</sup>) The first online posting of a conventional firm commitment underwriting occurred in 1996, when Solomon Brothers created an Internet site for the initial public offering of Berkshire Hathaway’s new Class B stock. The site was only used to create interest, since the Berkshire Hathaway prospectus itself could not be seen on the Web site and was only obtainable by directly contacting the underwriters by telephone or mail. In the subsequent 1996 public stock offering of Yahoo!, the viewer could download the Yahoo! prospectus directly from the Web site. However, orders for shares could not be made on the Web. Orders could only be placed by contacting the underwriters by phone or mail or through another broker-dealer.

Wit Capital Corp. is an example of a discount brokerage firm which provides opportunities for underwritten IPOs to be posted on its web site ([www.witcapital.com](http://www.witcapital.com)). Wit Capital became the first “e-manager” of an otherwise standard public offering on Form S-1, when a 1998 IPO co-managed by J. P. Morgan, Bear Stearns and Volpe Brown Whelan listed Wit Capital as “facilitating on-line distribution” of the shares.<sup>168</sup> Other online firms have also begun to receive slots in the underwriting syndicates of IPOs, particularly those involving Internet-related issuers. Such issuers like to have a portion of their shares sold to online investors, who they perceive as enthusiastic over IPO products and as likely to lend some extra “oomph” to a public offering.<sup>169</sup>

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<sup>166</sup>Securities Act §18(b)(4)(D), 15 U.S.C. 77r(b)(4)(D) added by NSMIA §102(a).

<sup>167</sup>Reg. A and Forms SB-1 and SB-2 are promulgated pursuant to the small offering exemption in Section 3(b) of the Securities Act and hence are not made exempt by NSMIA from state qualification requirements.

<sup>168</sup>SEC File No. 33-60837, prospectus at 45-46.

<sup>169</sup>R. Buckman, *Internet Brokerage Firms Click Into Online Stock Underwriting*, WALL ST. J. (Jan. 28, 1998) C-1, C-28.

b. The “Dutch Auction” Process.

Another method of underwriting IPOs online is the “Dutch auction” system, first used in equity online IPOs by W.R. Hambrecht & Co., a new venture of William Hambrecht, co-founder of Hambrecht & Quist. The Dutch Auction system allows institutions, professionals and individual investors to enter bids at a fixed price on a confidential basis on the Internet for a certain number of shares being publicly offered. The total of all the best bids which, in the aggregate, cover the minimum number of shares being offered, win the right to purchase such shares pro rata at the lowest of the best bids. For example, if one million shares are offered and the best of the total bids equaling one million shares range from 15 to 20, all of the one million shares would be sold at 15 to those who had 15 or higher. (All bids under 15 would be eliminated.) To date, the Hambrecht Dutch Auction is not yet conducted as a DPO with the firm simply acting as agent, but as a hybrid species of firm underwriting. The SEC has been requiring the firm to treat the bids as indications of interest and to take title to the registered securities before promptly confirming their resale to the successful auction bidders. Accordingly, the firm is “at risk” in much the same way as the traditional underwriter. The Dutch Auction has a distinct advantage over DPOs, in that the underwriter to a certain extent can “work” the institutions and its existing base of clients and conducts roadshows, all for the purpose of stimulating interest in the offering.

During 2000, the Dutch Auction Process was extended to debt offerings when W.R. Hambrecht & Co. managed the online debt offering of \$300 million in Dow Chemical bonds.<sup>170</sup> Also in 2000, the same firm announced that it was preparing an auction platform for secondary offerings.<sup>171</sup> In early 2001, the firm claimed to be preparing to launch a new auction system for blocks of securities.<sup>172</sup>

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<sup>170</sup>James Christie, *Bond Auctions Find Takers on Web*, RED HERRING ONLINE, [www.redherring.com/industries/2000/0825/ind-bonds082500.html](http://www.redherring.com/industries/2000/0825/ind-bonds082500.html) (visited Feb. 4, 2001); Matt Marshall, *WR Hambrecht Sells Corporate Banks on the Net*, MERCURY NEWS (Aug. 16, 2000) 2C.

<sup>171</sup>W.R. Hambrecht Develops Dutch Auction for Secondary Offerings, FIN. NETNEWS (Sept. 4, 2001) 1.

<sup>172</sup>W.R. Hambrecht Eyes Sweden; To Introduce New Auction Method, FIN. NETNEWS (Jan. 22, 2001) 1, 10.

D. Jurisdictional Aspects of Cybersecurity.

1. Prescriptive Jurisdiction Under Federal Securities Laws of the United States.

U.S. federal securities laws afford only limited guidance on the extent to which U.S. antifraud provisions apply to securities transactions that are primarily extra-territorial but have some connection to the United States. Courts have struggled for years to delineate the parameters.<sup>173</sup> The Securities Act defines its jurisdictional reach to include “any means or instruments . . . of communication in interstate commerce” to sell securities that are not either registered or exempt from registration.<sup>174</sup> Jurisdiction under the Exchange Act likewise applies to any broker or dealer (including any foreign broker or dealer), who makes use of any “instrumentality of interstate commerce to effect transactions in, or induce or attempt to induce the purchase or sale” of any security by means of an instrument of communication in interstate commerce.<sup>175</sup> The 1934 Act states that it “shall not apply to any person insofar as he transacts business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules as the [Securities and Exchange] Commission may prescribe as necessary or appropriate to prevent the evasion of this chapter.”<sup>176</sup> The Exchange Act, as interpreted by the SEC, does not apply to offers, offers to sell, or sales outside the U.S.<sup>177</sup>

The best known tests for determining the existence of subject matter jurisdiction are the “conduct” test and “effects” test. Under the conduct test, even if the fraud is consummated outside the U.S., federal courts will take jurisdiction over the subject matter when fraudulent conduct (or conduct integrally tied in with fraud) occurs in the U.S.<sup>178</sup> Under the effects test, subject matter would exist when otherwise international securities transactions have a “substantial and foreseeable injurious” effect in a U.S.<sup>179</sup> Under the Restatement (Third) of Foreign Relations Law, the U.S. can regulate conduct outside the U.S. that is significantly related to a securities transaction carried out, or intended to be carried

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<sup>173</sup>See, e.g., *Robinson v. TCI/US West Communications, Inc.*, 117 F.3d 900, 904-05 (5th Cir. 1997): “[w]ith one small exception the [1934 Act] . . . does nothing to address the circumstances under which American courts have subject matter jurisdiction to hear suits involving foreign transactions.

<sup>174</sup>Section 5 of the Securities Act; 15 U.S.C.A. §77e.

<sup>175</sup>Section 15 of the 1934 Act; 15 U.S.C.A. §78o.

<sup>176</sup>15 U.S.C. §78dd(b).

<sup>177</sup>SEC Release No. 33-6863 55 Fed. Reg. 18306 at 18309 (May 2, 1996).

<sup>178</sup>See *Tamari v. Bache & Co. (Lebanon) S.A.L.*, 730 F.2d 1103, 1107-08 (7th Cir. 1984).

<sup>179</sup>*Id.* at 1108. See *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1982).

out, on an organized securities market or otherwise predominantly within the U.S., if the conduct has, or is intended to have, a substantial effect in the U.S.<sup>180</sup>

The Second Circuit Court of Appeals has found that neither the Securities Act nor the Exchange Act could be invoked to cover the sale by a foreign corporation of foreign securities to another foreign entity, even though the sales allegedly were made to the foreign entity's president while he was in Florida.<sup>181</sup> The Second Circuit, applying the "conduct test," found "nearly de minimis U.S. interest" under the Securities Act in the transactions.<sup>182</sup> As to the broader jurisdiction under the Exchange Act, the court also found insufficient U.S. interest. It held that, without some additional factor, a series of phone calls to a transient foreign national in the U.S. was not enough to make prescriptive jurisdiction reasonable within the meaning of the Restatement (3rd) of Foreign Relations Law Section 416 [jurisdiction to regulate securities activities] and Section 403 [factors to determine whether prescriptive jurisdiction is reasonable]. It found this especially true where another country had a clear and strong interest in redressing the wrong:

"In this case, there is no U.S. party to protect or punish, despite the fact that the most important piece of the alleged fraud—reliance on a misrepresentation—may have taken place in this country. Congress may not be presumed to have prescribed rules governing activity with strong connections to another country, if the exercise of such jurisdiction would be unreasonable in light of the established principles of U.S. and international law. . . . And, the answer to the question of what jurisdiction is reasonable depends in part on the regulated subject matter."  
147 F.3d at 130-131.

In contrast, the Seventh Circuit ruled in 1998 that the Exchange Act gave jurisdiction over an alleged fraud of a Malaysian company where the Caribbean-incorporated defendant allegedly conceived and planned its scheme in the U.S., from which solicitations were sent and where payments were received.<sup>183</sup>

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<sup>180</sup>RESTATEMENT (3rd) OF THE FOREIGN RELATIONS LAW OF THE U.S. §416 (1987).

<sup>181</sup>*Europe and Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118 (2d Cir. 1988).

<sup>182</sup>147 F.3d at 126.

<sup>183</sup>*Kauthar SDN BHD v. Sternberg*, 1998 WL 388921 (7th Cir. 1998).

## 2. [Prescriptive Jurisdiction Under U.S. State Securities Laws.](#)

Most of the states within the U.S. have adopted some form of the jurisdictional provisions of the Uniform Securities Act (“USA”). The USA extends a state’s jurisdictional reach to persons offering to buy or sell securities “in [a given] . . . state.”<sup>184</sup> In fact, the constitutionally permissible adjudicated jurisdiction of states is even broader than the USA’s words suggest. Under a typical long-arm statute, even if a defendant does not have substantial or continuous activities within a State, personal jurisdiction can still be based on purposeful direction of activities toward the State.<sup>185</sup> The USA tightens the jurisdictional inquiry by providing that an offer to sell or buy is made “in this state, whether or not either party is then present in this state, when the offer (1) *originates from* this state or (2) is *directed by the offeror to this state and received at the place to which it is directed . . .*”<sup>186</sup>

## 3. [The Conflict Between the Internet and Traditional Jurisdictional Principles.](#)

The forgoing principles of jurisdiction become more difficult to apply in the borderless context of the Internet. Information over the Internet passes through a network of networks, some linked to other computers or networks, some not. Not only can messages between and among computers travel along much different routes, but “packet switching” communication protocols allow individual messages to be subdivided into smaller “packets” which are then sent independently to a destination where they are automatically reassembled by the receiving computer.<sup>187</sup> Since the Internet is indifferent to the actual location of computers among which information is routed, there is no necessary connection between an Internet address and a physical jurisdiction.<sup>188</sup> Moreover, Web sites can be interconnected, regardless of location, by the use of hyperlinks. Information that arrives on a Web site within a given jurisdiction may flow from a linked site entirely outside that jurisdiction.<sup>189</sup> Finally, notwithstanding the

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<sup>184</sup>Section 414(a) of the USA.

<sup>185</sup>*Burger King Corp. v. Rudzewicz*, *supra*, note 127, 471 U.S. at 472-76; *Davis v. Metro Productions Inc.*, 885 F.2d 515, 520 (9th Cir. 1989) (tax shelter investment contracts sold to Arizona resident and delivered in Arizona formed constitutional basis for Arizona’s long-arm jurisdiction).

<sup>186</sup>Section 414(c) of the USA; emphasis added.

<sup>187</sup>See stipulated facts regarding the Internet in *American Civil Liberties Union v. Reno*, 929 F. Supp. 824, 830-32 (E.D. Pa. 1996).

<sup>188</sup>D. Johnson and D. Post, *Law and Borders—The Rise of Law in Cyberspace*, 48 STAN. L. REV. 1367, 1371 (1996).

<sup>189</sup>The Internet also uses “caching,” i.e., the process of copying information to servers in order to shorten the time of future trips to a Web site. The Internet server may be located in a different jurisdiction from the site that originates the information, and may store partial or complete duplicates of materials from  
(continued . . . )

Internet's complex structure, the Internet is predominately a passive system; Internet communication only occurs when initiated by a user.

#### 4. [The SEC's Offshore Internet Jurisdictional Release.](#)

The SEC has in the past interpreted the Exchange Act broadly enough to require an off-shore broker or dealer to register under that Act where its only U.S. activity is execution of unsolicited orders from persons in the U.S.<sup>190</sup> Such an interpretation is not inconsistent with either concepts of due process or international law. It will be recalled that, under international law, a country may assert jurisdiction over a non-resident where the assertion of jurisdiction would be reasonable.<sup>191</sup> The standards include, among others, whether the non-resident carried on activity in the country only in respect of such activity, or whether the non-resident carried on, outside the country, an activity having a substantial, direct, and foreseeable effect within the country with respect to such activity.<sup>192</sup> Under these rules, a court in one country could assert jurisdiction over a foreign company under the "doing business" or "substantial and foreseeable effects" tests where financial information is directed by e-mail into the country. The accessibility of a Web site to residents of a particular country might also be considered sufficient to assert personal jurisdiction over an individual or company running the Web site.

In April, 1998 the SEC issued an interpretive release on the application of federal securities laws to offshore Internet offers, securities transactions and advertising of investment services.<sup>193</sup> The SEC's release sought to "clarify when the posting of offering or solicitation materials" on Web sites would not be deemed activity taking place in the United States for purposes of federal securities laws.<sup>194</sup> The SEC adopted a rationale that resembles that used by the NASAA in determining the application of state blue-sky laws.<sup>195</sup> Essentially, the SEC stated that it will not view issuers, broker-dealers, exchanges and investment advisers to

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( . . . continued)

the originating site. The user of the World Wide Web will never see any difference between the cached materials and the original. *American Civil Liberties Union v. Reno*, *supra* note 195, 929 F. Supp. at 848-49.

<sup>190</sup>Registration Requirements for Foreign Broker-Dealers, SEC Release No. 34-27,017 (July 11, 1989).

<sup>191</sup>See Section 421, RESTATEMENT (THIRD) OF THE LAW OF FOREIGN RELATIONS (1987).

<sup>192</sup>See notes 133-138 *supra* and accompanying text.

<sup>193</sup>Release 33-7516.

<sup>194</sup>*Id.*, Part I. The release applied only to posting on Web sites, not to targeted kinds of communication such as e-mail.

<sup>195</sup>See Subsection IV.G.3 below for NASAA approach.

be subject to registration requirements of the U.S. securities laws if they are not “targeted to the United States.”<sup>196</sup>

Thus, the SEC generally will not consider an offshore Internet offer made by a non-U.S. offeror as targeted at the U.S. if (1) the Web site includes a prominent disclaimer making clear that the offer is directed only to countries *other* than the U.S., and (2) the Web site offeror implements procedures that are “reasonably designed to guard against sales to U.S. persons in the offshore offering.”<sup>197</sup> There are several ways that an offer to non-U.S. locales can be expressed. The site could state specifically that the securities are not available to U.S. persons or in the U.S. Alternatively, it could list the countries in which the securities are being offered.

There are likewise several ways to guard against sales to U.S. persons. For example, the offeror could determine the buyer’s residence by obtaining the purchaser’s mailing address or telephone number (including area code) before sale. If the offshore party received indications that the purchaser is a U.S. resident, such as U.S. taxpayer identification number or payment drawn on a U.S. bank, then the party might on notice that additional steps need to be taken to verify that a U.S. resident is not involved.<sup>198</sup> Offshore offerors who use third-party Web services to post offering materials would be subject to similar precautions, and also would be have to install additional precautions if the third-party Web site generated interest in the offering. The offshore offeror which uses a third-party site that had a significant number of U.S. subscribers or clients would be required to limit access to the materials to those who could demonstrate that they are not U.S. residents.<sup>199</sup>

Where the off-shore offering is made by a U.S. issuer, stricter measures would be required because U.S. residents can more readily obtain access to the offer. Accordingly, the SEC requires a U.S. issuer to implement password procedures by which access to the Internet offer is limited to persons who can obtain a password to the Web site by demonstrating that they are not U.S. citizens.<sup>200</sup>

If Internet offerings are made by a foreign investment company, similar precautions must be taken not to target U.S. persons in order to avoid registration

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<sup>196</sup>Release 33-7516, Part I.

<sup>197</sup>*Id.*

<sup>198</sup>*Id.*, Part III.B.

<sup>199</sup>*Id.* Part III.D.

<sup>200</sup>*Id.*, Part IV.B.

and regulations under the 1940 Act. From a practical standpoint, the SEC's historical reluctance to allow foreign investment companies to register under the 1940 Act means that foreign investment companies can only make private placement in the U.S.<sup>201</sup> When an offer is made offshore on the Internet and with a concurrent private offer in the U.S., the offeror must guard against indirectly using the Internet offer to stimulate participants in the private U.S. offer.<sup>202</sup>

The SEC's interpretation requires a broker-dealer who wants to avoid U.S. jurisdiction to take measures reasonably designed to ensure that it does not effect securities transactions with U.S. persons as a result of Internet activity. For example, the use of disclaimers coupled with actual refusal to deal with anyone whom the broker-dealer has reason to believe is a U.S. person will support exemption from U.S. broker-dealer registration. As suggested in the SEC interpretation, a foreign broker-dealer should require potential customers to provide sufficient information on residency.

By like token, the SEC will not apply exchange registration requirements to a foreign exchange that sponsors its own Web site generally advertising its quotes or allowing orders to be directed through its Web site so long as it takes steps reasonably designed to prevent U.S. persons from directing orders through the site to the exchange. Regardless of what precautions are taken by the issuer, the SEC will view solicitations as being subject to federal securities laws if their content appears to be targeted at U.S. persons. For instance, the SEC cited offshore offers that emphasize the investor's ability to avoid U.S. taxes on the investment.<sup>203</sup>

## 5. [Regulation S Offerings.](#)

Many securities offerings are made offshore pursuant to the exemption under Regulation S. The Internet poses special issues with respect to Regulation S, some of which are addressed by Release 33-7516, discussed above. In international and global offerings, securities are often marketed into jurisdictions where the customary practice is to broadly disseminate publicity as a means of generating investor interest. In its release adopting Regulation S, the SEC specifically provided for offshore publicity practices stating that:

“The Regulation generally will not interfere with activities conducted outside the United States, if such activities are

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<sup>201</sup>*Id.*, Part V.

<sup>202</sup>*Id.*, Parts IV.A., V.A.

<sup>203</sup>*Id.*, Part III.B.

legal and customary in the foreign jurisdiction. Such activities may relate to a foreign distribution or to the ordinary course of an issuer's business. In this regard, activities carried out abroad such as advertising in newspapers or magazines with no general circulation in the United States or granting interviews or conducting promotional seminars outside the United States and not targeted to the United States will not preclude reliance on the Regulation's safe harbor."

The key restriction under Regulation S is its prohibition on offers and directed selling efforts in the U.S. Non-U.S. issuers generally regard publication on their websites as conduct outside the United States. Release 33-7516 provides guidance as to the circumstances in which the SEC would view website communication with respect to offshore offerings as activity outside the United States for purposes of Section 5 of the Securities Act, because, as discussed, website communications not targeted to the United States should not be viewed as activity outside the United States so long as there is implementation of "measures that are reasonably designed to guard against sales . . . to U.S. persons."

When a Regulation S offering is made in conjunction with a registered U.S. offering, the electronic roadshow should be password-protected to assure that U.S. investors do not review the offshore roadshow. However, as long as U.S. persons are not given access to the offshore electronic roadshow, the limitations on (i) downloading and copying, (ii) number of viewings, (iii) number and types of persons granted access and; (iv) prior delivery of the preliminary prospectus will be based principally on concerns about antifraud liability and leakage of copies of the roadshow into the United States.<sup>204</sup>

When a non-U.S. offeror commences a private offering in the United States at the same time it is conducting an offshore Internet offering, the SEC suggests that additional procedures should be implemented to protect against the Internet communications resulting in the solicitation of investors in the exempt offering. Release 33-7516 makes clear, however, that "any investor solicited by the issuer or underwriter prior to or independent of the Web site posting could participate in the private offer, regardless of whether the investor may have

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<sup>204</sup> Antifraud prohibitions will still apply to the Web site offerings. The Commission warned in Release 33-7516 "even in the absence of sales in the United States, we will take appropriate enforcement action whenever we believe that fraudulent or manipulative Internet activities have originated in the United States or placed U.S. investors at risk."

viewed the posted offshore offering materials.” Any Internet posting should therefore only relate to the offshore offering.

6. U.S. Blue-Sky Administrators.

The Internet from the onset posed an issue whether offerings posted on a Website without more might be subject to the blue-sky law of every jurisdiction from which they were accessible. Certainly, whether an Internet offer “originates” from a given state should not be based on the physical location of the essentially passive circuits carrying the message. Regardless of the multiplicity of networks and computers that an electronic message may traverse, the place where information is entered into a Web site or into e-mail is the point of origination. Whether an Internet-based offer to buy or sell is “directed” into a given state is a more complex factual inquiry. If an offer to sell securities were mailed or communicated by telephone to a person in a forum state, personal jurisdiction in that state should apply.<sup>205</sup> By like token, an e-mail offer by Internet directly to the a resident of a state would similarly constitute a basis for jurisdiction in that state. So would acceptance by an out-of-state issuer of an e-mail from person in the forum state, subscribing to a general offering posted on the World Wide Web.

However, mere posting of the existence of an offering on the World Wide Web, without more, is different. Standing alone, it constitutes insufficient evidence that the offer is specifically “directed” to persons in every state. The offer may, indeed, not be intended to be accepted by persons in certain states. In order to reconcile technology, practicality and due process, the North American Securities Administrators Association (NASAA) became the first super-regulatory entity to adopt a jurisdictional policy that would facilitate electronic commerce in securities. The NASAA adopted a model rule, under which states will generally not attempt to assert jurisdiction over an offering if the Web site contains a disclaimer essentially stating that no offers or sales are being made to any resident of that state, the site excludes such residents from access to the purchasing screens and in fact no sales are made to residents of that state.<sup>206</sup>

As of July 2001, 40 states had adopted a version of the NASAA safe-harbor, either by statute, regulation, interpretation or no-action letter.<sup>207</sup> Commonly, the disclaimer is contained in a page linked to the home page of the

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<sup>205</sup>1 J. LONG, BLUE SKY LAW (1997 rev.), §3.04[2] at 3-26, 3-27.

<sup>206</sup>Model NASAA Interpretive Order and Resolution, posted at NASAA’s official Web site, [www.nasaa.org/bluesky/guidelines/internetadv.html](http://www.nasaa.org/bluesky/guidelines/internetadv.html). The blue-sky authorities in Pennsylvania were actually the first to espouse this doctrine.

<sup>207</sup>See BLUE SKY L. REP. (CCH) ¶6481.

offering. A preferred technique is to request entry of the viewer's address and ZIP code before the viewer is allowed to access the offering materials. If the viewer resides in a state in which the offering has not been qualified, access is denied. Of course, the viewer might choose to lie, but it can be argued with some logic that a Website operator cannot reasonably "foresee" that viewers would lie.

NASAA also adopted in 1997 a practical approach to jurisdiction over Internet-based broker-dealers and investment advisors.<sup>208</sup> NASAA's policy exempts from the definition of "transacting business" within a state for purposes of Sections 201(a) and 201(c) of the Uniform Securities Act those communications by out-of-state broker-dealers, investment advisers, agents and representatives that involve generalized information about products and services where it is clearly stated that the person may only transact business in the state if first registered or otherwise exempted, where the person does not attempt to effect transactions in securities or render personalized investment advice, uses "firewalls" against directed communications, and also uses specified legends.<sup>209</sup>

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<sup>208</sup>The policy is available on the Internet at [www.nasaa.org/bluesky/guidelines/internetadv.html](http://www.nasaa.org/bluesky/guidelines/internetadv.html). See also Interpretive Order Concerning Broker-Dealers, Investment Advisers, Broker-Dealer Agents and Investment Adviser Representatives Using the Internet for General Dissemination of Information on Products and Services (Apr. 27, 1997) CCH NASAA Reports ¶2191. As of July, 2001, thirty-two states had adopted a version of the safe harbor. 1 BLUE SKY L. REP. (CCH) ¶6481.

<sup>209</sup>Broker-dealers, investment advisers, broker-dealer agents ("BD agents") and investment adviser representatives or associated person ("IA reps") who use the Internet to distribute information on available products and services directed generally to anyone having access to the Internet, and transmitted through the Internet, will not be deemed to be "transacting business" in the state if all of the following conditions are met:

- A. The communication contains a legend clearly stating that:
  - (1) the broker-dealer, investment adviser, BD agent or IA rep may only transact business in a particular state if first registered, excluded or exempted from state broker-dealer, investment adviser, BD agent or IA rep requirements, as the case may be; and
  - (2) follow-up, individualized responses to persons in a particular state by such broker-dealer, investment adviser, BD agent or IA rep that involve either the effecting or attempting to effect transactions in securities or the rendering of personalized investment advice for compensation, as the case may be, will not be made absent compliance with the state's broker-dealer, investment adviser, BD agent or IA rep requirements, or pursuant to an applicable state exemption or exclusion; and
  - a. for information concerning the licensure status or disciplinary history of a broker-dealer, investment adviser, BD agent or IA rep, a consumer should contact his or her state securities law administrator.
- B. The Internet communication contains a mechanism, including without limitation technical "firewalls" or other implemented policies and procedures, designed to ensure that prior to any subsequent, direct communication with prospective customers or clients in the state, the broker-dealer, investment adviser, BD agent or IA rep is first registered in the state or qualifies for an exemption or exclusion from such

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NASAA's approach should facilitate the use of the Web by those smaller or regional securities professionals who focus their activities in a limited geographical area.

E. [Conclusion.](#)

Digital communication and cybersecurities are no longer in their infancy, but in their childhood. Their ultimate impacts on public offerings and capital formation are impossible to predict so soon in this evolution. However, the Securities Industry Association has pointed out some interesting metrics. First, the number of Internet households in the United States has climbed from 1.64 million in 1998 to 9.27 million in 2000.<sup>210</sup> In the same time period, the online trades jumped from 24% of all equity trades to 48%-in effect, a doubling.<sup>211</sup> Second, the number and dollar amount of online offerings made to institutional investors is growing rapidly and will doubtlessly surpass the volume of online sales to retail investors.<sup>212</sup> This reflects the general history of e-commerce, where markets initially are business-to-consumers (B2C), but are then over-taken by business-to-business (B2B). Third, as issuers can reach more potential investors faster, somewhat reducing the advantages of intermediaries will diminish. Moreover, the individual investor has been given more power, both with regard to pricing (as discount brokers drive down commissions) and to information and analytical tools.

It remains to be seen whether the cost to build software systems that will allow for larger and more sophisticated securities offerings in the future will be so substantial that it will limit the number of "players." The past several years have shown, new kinds of intermediaries will evolve, both new entries as well as retooled versions of the traditional intermediaries. Because of the global and

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requirement. (This provision is not to be construed to relieve a broker-dealer, investment adviser, BD agent or IA rep who is registered in a state from any applicable registration requirement with respect to the offer or sale of securities in such state);

- C. The Internet communications shall not involve either effecting or attempting to effect transactions in securities, or the rendering of personalized investment advice for compensation, as the case may be, in such state over the Internet, but shall be limited to the dissemination of general information on products and services.
- D. Prominent disclosure of a BD agent's or IA rep's affiliation with a broker-dealer or investment adviser is made and appropriate internal controls over content and dissemination are retained by the responsible persons.

<sup>210</sup>Letter from Securities Industries Association to Jonathan G. Katz, Secretary of SEC (Aug. 25, 2000) [the "SIA Letter"], 8.

<sup>211</sup>Presentation by Robert Mendelson, 28TH ANNUAL SAN DIEGO SEC. L. INST (Jan. 25, 2001).

<sup>212</sup>SIA Letter, 12.

instantaneous nature of the World Wide Web, jurisdictional barriers are more vulnerable than ever. International cooperation and the development of common principles is of great importance. In any event, the offering of securities both publicly and privately can be accomplished in many more ways and with greater efficiency and equality of access than was available as recently as four years ago.

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